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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1946

No. 287

J. ROBERT BAZLEY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED JULY 11, 1946.

CERTIORARI GRANTED OCTOBER 14, 1946.

IN THE

United States Circuit Court of Appeals

FOR THE THIRD CIRCUIT.

No. 8947.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition to Review the Decision of The Tax Court of the United States.

Appendix to Brief for Petitioner.

HENRY S. DRINKER,
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Attorneys for Petitioner.

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TABLE OF CONTENTS OF APPENDIX.

	Page
RELEVANT DOCKET ENTRIES	1a
PETITION	3a
Exhibit A. Notice of Deficiency, Dated February 11, 1943	8a
ANSWER	12a
STIPULATION OF FACTS	14a
Exhibit 1-A. Minutes of Special Meeting of Board of Directors of J. Robert Bazley, Inc., February 6, 1939	18a
Exhibit 2-B. Plan of Reorganization, Dated as of February 1, 1939	21a
Exhibit 3-C. Minutes of Special Meeting of Stockholders of J. Robert Bazley, Inc., February 16, 1939	23a
Exhibit 4-D. Balance Sheets of J. Robert Bazley, Inc., April 30, 1938, and April 30, 1939	33a
CORRECTED TRANSCRIPT OF PROCEEDINGS	36a
Opening Statement on Behalf of the Petitioner by Mr. Morrison	37a
Opening Statement on Behalf of the Respondent by Mr. McFarland	40a
Witnesses on Behalf of Petitioner.	
James Robert Bazley—	
Direct Examination	47a
Cross-Examination	52a
Re-Direct Examination	55a
Re-Cross-Examination	58a
Re-Direct Examination	60a
Re-Cross-Examination	62a
Re-Direct Examination	63a
Re-Cross-Examination	71a
Re-Direct Examination	71a
William Reubin Lefferts—	
Direct Examination	74a
Cross-Examination	78a
Re-Direct Examination	79a
Alfred Day—	
Direct Examination	84a
MEMORANDUM FINDINGS OF FACT AND OPINION	89a
DECISION, ENTERED MARCH 2, 1945	105a

Proceedings in U. S. C. C. A., Third Circuit 106
Opinion, O'Connell, J., January 8, 1946 106
Judgment 116
Motion to extend time for filing petition for rehearing 117
Petition for rehearing 118
Order granting petition for rehearing 125
Order withdrawing opinion of January 8, 1946 125
Opinion, O'Connell, J., April 16, 1946 126
Dissenting opinion, Maris and Goodrich, JJ. 137
Judgment 141
Clerk's certificate 141
Order allowing certiorari 142

Appendix.

RELEVANT DOCKET ENTRIES.

May 5, 1943.	Petition received and filed. Taxpayer notified. Fee paid.
May 5, 1943.	Request for Circuit hearing in Philadelphia, Pa., filed by taxpayer. 5/6/43 Granted.
May 6, 1943.	Copy of petition served on General Counsel.
June 26, 1943.	Answer filed by General Counsel.
June 30, 1943.	Copy of answer served on taxpayer—Philadelphia, Pa.
July 26, 1944.	Hearing set Sept. 11, 1944—Philadelphia, Pa.
Sept. 12, 1944.	Hearing had before Judge Opper on merits. Motion to consolidate filed and granted. Stipulation of facts, appearance of Frederick E. S. Morrison and Calvin H. Rankin filed. Petitioner's brief due 10/27/44, Respondent's 10/27/44, replies 11/11/44.
Sept. 23, 1944.	Transcript of hearing 9/12/44 filed.
Oct. 25, 1944.	Motion to correct official report filed by taxpayer. 10/26/44 granted.
Oct. 27, 1944.	Brief filed by taxpayer. Copy served 11/14/44.
Oct. 27, 1944.	Motion for extension to 11/20/44 to file brief filed by General Counsel. 10/28/44 Granted.

Nov. 14, 1944.	Brief filed by General Counsel.
Nov. 28, 1944.	Motion for extension to Dec. 15, 1944 to file reply brief, filed by General Counsel. 11/29/44 Granted.
Nov. 30, 1944.	Motion for extension to Dec. 15, 1944 to file reply brief filed by taxpayer. 11/30/44 Granted.
Dec. 14, 1944.	Reply brief filed by taxpayer. 12/14/44 copy served.
Dec. 20, 1944.	Motion for leave to file the attached reply brief, reply brief lodged, filed by General Counsel. 12/21/44 Granted.
Jan. 19, 1945.	Motion for leave to substitute the attached page 5 in the above reply brief filed by General Counsel. 1/22/45 Granted.
Feb. 28, 1945.	Findings of fact and opinion rendered, Opper, J. Decision will be entered for respondent.
Mar. 2, 1945.	Decision entered, Opper, J., Div. 14. 3/1/45 Copy served.
Apr. ~~12~~, 1945.	Petition for review by U. S. Circuit Court of Appeals, Third Circuit filed by taxpayer.
Apr. 12, 1945.	Notice of filing petition for review sent to J.-P. Wenchel filed.
Apr. 13, 1945.	Proof of service of petition for review filed.
Apr. 23, 1945.	Designation of record filed by taxpayer, with proof of service thereon.

PETITION.

The above named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, signed by E. A. McGinnes, Acting Revenue Agent in Charge (Symbols SN-IT-1, BMN/pk), dated February 11, 1943, and as a basis of this proceeding alleges as follows:

I. Petitioner is a citizen of the United States residing in Pottsville, Pennsylvania. The return of the Petitioner for the calendar year 1939, the period here involved, was filed on or about March 15, 1940 with the Collector of Internal Revenue for the First District of Pennsylvania.

II. A notice of deficiency (a copy of which is attached hereto and marked Exhibit A) was mailed to the Petitioner on February 11, 1943.

III. The tax in controversy is income tax for the calendar year 1939 in the amount of $214,170.52, which is the amount of deficiency erroneously determined by Respondent.

IV. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

The Commissioner of Internal Revenue in computing Petitioner's net income for the year 1939 erroneously and illegally

(1) added to Petitioner's taxable net income the sum of $319,200. on the alleged ground as set forth in the deficiency letter (see Exhibit A—p. 2 attached)

> "(a) Other income has been increased $319,200. representing the fair market value of bonds of J. Robert Bazley, Inc. received in exchange of common stock of that corporation.
>
> "It is held that in this transaction, you received income of $319,200. which is taxable in your return for the year 1939."

Whereas Petitioner alleges that no taxable income or gain was realized upon the exchange by him in 1939 of 798 shares of common stock of $100. par value each of J. Robert Bazley, Inc. for $319,200. principal amount of 20 year 6% debenture bonds, and 3990 shares of new common stock without par value of said corporation for the reason that no gain or loss is recognized by the provisions of Sections 112 (b) (3) and (g) of the Internal Revenue Code;

or (2) in the alternative, the Commissioner erroneously determined the fair market value of the $319,200. principal amount of 20 year 6% debenture bonds of J. Robert Bazley, Inc. at $319,200., whereas Petitioner alleges that said fair market value was not in excess of 50% of the principal amount of said bonds;

or (3) in the further alternative, the Commissioner erroneously determined that such alleged income (which Petitioner does not admit) is taxable as ordinary income, whereas if it is held that income or gain was realized by Petitioner upon the exchange by him of stock by J. Robert Bazley, Inc. for stock and bonds of said corporation as above set forth, then such income or gain is subject only to tax at the capital gain rate provided by Section 117 of the Internal Revenue Code.

V. The facts upon which Petitioner relies as the basis of this proceeding are as follows:

(1) On May 1, 1930 Petitioner became the owner of 998 shares of common stock of $100. par value each of J. Robert Bazley, Inc. at a cost to Petitioner of $100. per share, of which he continued to own and did own 798 shares up to the time of the recapitalization of J. Robert Bazley, Inc. in 1939, which recapitalization is hereinafter more fully set forth.

(2) On February 6, 1939 the Board of Directors of J. Robert Bazley, Inc., at a special meeting held at the principal office of the company at Port Carbon, Pa., unanimously adopted a Plan of Reorganization and Recapitalization dated as of February 1, 1939.

(3) The Plan of Reorganization and Recapitalization was unanimously approved by the stockholders of J. Robert Bazley, Inc. at a special meeting held at the office of the company at Port Carbon, Pa. on February 16, 1939.

(4) Under the Plan of Reorganization and Recapitalization the capital stock of the company was increased from 1000 shares of common stock of a par value of $100. per share to 5000 shares of common stock of no par value, with a stated value of $300,000., and the corporate indebtedness was increased from nothing to $400,000. represented by an issue of 6% debenture bonds due February 1, 1959. The plan further provided that the 1000 shares of outstanding common stock of the corporation were to be exchanged for the 5000 shares of the new common stock without par value and the $400,000. principal amount of debenture bond securities.

(5) Pursuant to the Plan of Reorganization and Recapitalization, the corporation exchanged the 5000 shares of new common stock without par value and $400,000. of principal amount of debenture bonds for the 1000 shares of common stock outstanding. The exchange was made on the basis of 5 shares of new common stock without par value and $400. of debenture bonds for each share of old common stock outstanding. The 1000 shares of old common stock were then cancelled on the books of the corporation.

(6) The Petitioner in April, 1939, pursuant to and in accordance with the terms of the Plan of Reorganization and Recapitalization received in exchange for his 798 shares of $100. par value common stock of J. Robert Bazley, Inc., 3990 shares of no par value common stock and $319,200. principal amount of 20 year 6% debenture

bonds of the same corporation. The Petitioner contends that he did not realize any taxable income as a result of this exchange since this transaction constituted a reorganization and was nontaxable within the meaning of Section 112 (b) (3) and 112 (g) of the Internal Revenue Code. The Commissioner erroneously included in the taxable income of Petitioner for the year 1939 the sum of $319,200. representing the principal amount of the debenture bonds received in the above exchange.

In the alternative, if it be held that the Petitioner realized taxable income in 1939 to the extent of the fair market value of the debenture bonds received in the exchange, then the Petitioner contends that the Commissioner erred in determining the fair market value of the $319,200. principal amount of 20 year 6% debenture bonds of J. Robert Bazley, Inc. at $319,200. The Petitioner contends that the fair market value of the $319,200. principal amount of 20 year 6% debenture bonds of J. Robert Bazley, Inc. was not in excess of $159,600.

In the further alternative, if it be held that Petitioner realized taxable income or gain in 1939 as a result of the foregoing exchange, then Petitioner contends that the Commissioner erred in determining that such income or gain was ordinary income instead of capital gain as provided by Section 117 of the Internal Revenue Code.

WHEREFORE, Petitioner prays that your court will hear the proceedings and determine

(1) That the Petitioner did not realize taxable income in the amount of $319,200., or in any amount, as a result of his exchange of 798 shares of common stock of J. Robert Bazley, Inc. for 3990 shares of no par value common stock and $319,200. principal amount of 20 year 6% debenture bonds of the same corporation;

or, in the alternative, that the fair market value of $319,200. principal amount of 20 year 6% debenture bonds of J. Robert Bazley, Inc. was not in excess of $159,600;

or, in the further alternative, if it be held that Petitioner realized taxable income or gain as a result of the foregoing exchange, then such gain is taxable at the capital gain rate of the Internal Revenue Code;

(2) that there is no deficiency owing by the Petitioner for the year 1939.

Respectfully submitted,

(Sgd.) FREDERICK E. S. MORRISON,
Frederick E. S. Morrison,
(Sgd.) CALVIN H. RANKIN,
Calvin H. Rankin,
(Sgd.) LESLIE M. SWOPE,
Leslie M. Swope,
Counsel for Petitioner,
1429 Walnut Street,
Philadelphia, Pa.

COMMONWEALTH OF PENNSYLVANIA, }
COUNTY OF SCHUYLKILL, } *ss.:*

J. ROBERT BAZLEY, being duly sworn according to law, deposes and says that he is the Petitioner above-named; that he has read the foregoing Petition and is familiar with the statements contained therein; and that the facts stated therein are true.

J. ROBERT BAZLEY.

Sworn to and subscribed before me this 4th day of May, A. D., 1943.

RUSSELL L. HERSHBERGER,
Notary Public.

(Seal)

My Commission Expires March 8, 1947.

EXHIBIT A.

SN-IT-1

TREASURY DEPARTMENT
Internal Revenue Service
Philadelphia, Pa.

February 11, 1943.

Office of
Internal Revenue Agent in Charge
Room 1100 Gimbel Building
Philadelphia Division
Mr. J. Robert Bazley,
Post Office Box 117,
Pottsville, Pennsylvania.

Sir:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1939, discloses a deficiency of $214,170.52, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the Tax Court of the United States for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to this office. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

Guy T. Helvering,
Commissioner,

By
(Sgd) E. A. McGinnes
Acting Revenue Agent in Charge

Enclosures:

Statement
Form of Waiver
Form 1276

BMN/pk

STATEMENT

J. Robert Bazley,
Post Office Box 117,
Pottsville, Pennsylvania.

Tax Liability for Taxable Year Ended
December 31, 1939

	Liability	Assessed	Deficiency
Income Tax	$248,712.73	$34,542.21	$214,170.52

In making this determination of your income tax liability careful consideration has been given to the report of examination dated January 1, 1943, to your protest dated January 15, 1943, and to the statements made at conference held February 8, 1943.

A copy of this letter and statement has been mailed to your representative, Mr. William Reuben Lefferts, Lincoln-Liberty Building, Philadelphia, Pa., in accordance with the authority contained in the power of attorney executed by you and on file with this office.

Adjustments to Net Income

Net income as disclosed by return		$100,872.35
Unallowable deductions and additional income:		
(a) Other income	$319,200.00	
(b) other deductions	371.72	319,571.72
Net income adjusted		$420,444.07

Explanation of Adjustments

(a) Other income has been increased $319,200.00, representing the fair market value of bonds of J. Robert Bazley, Inc., received in exchange of common stock of that corporation.

It is held that in this transaction, you received income of $319,200.00 which is taxable in your return for the year 1939.

(b) Deduction for personal expenses disallowed.

Computation of Tax

Net income adjusted		$420,444.07
Plus: Net long-term loss		5,121.12
Ordinary net income		425,565.19
Less: Personal exemption	$2,500.00	
Credit for dependent	400.00	2,900.00
Balance (surtax net income)		422,665.19
Less: Earned income credit		1,400.00
Net income subject to normal tax		421,265.19
Normal tax at 4 percent on $421,265.19		16,850.61
Surtax on $422,665.19		233,412.33
Partial tax		250,262.94
Less: 30 percent of $5,121.12 (net long term loss)		1,536.34
Total tax		248,726.60
Less: Income tax paid at source		13.87
Correct income tax liability		248,712.73
Income tax assessed:		
Original, Account #201821	34,311.74	
Additional, Account #515668	230.47	34,542.21
Deficiency of income tax		$214,170.52

ANSWER.

Now comes the Commissioner of Internal Revenue by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition in the above-entitled proceeding admits and denies as follows:

I. Admits the allegations of the first sentence of paragraph I of the petition; admits that the return of petitioner for the calendar year 1939 was filed with the Collector of Internal Revenue for the First District of Pennsylvania; denies the remaining allegations of said paragraph I.

II. Admits the allegations of paragraph II of the petition.

III. Admits that the tax in controversy is income tax for the calendar year 1939; denies the remaining allegations of paragraph III of the petition.

IV. Denies the allegations of paragraph IV of the petition and the allegations of all divisions and subdivisions of said paragraph IV.

V. (1) Admits that prior to April, 1939, petitioner owned 798 shares of common stock, of $100.00 par value each, of J. Robert Bazley, Inc.; denies the remaining allegations of paragraph V (1) of the petition.

(2) and (3) Denies the allegations of paragraph V (2) and (3) of the petition.

(4) Admits that the capital stock of J. Robert Bazley, Inc., was increased from 1,000 shares of common stock of a par value of $100.00 per share to 5,000 shares of common stock of no par value, with a stated value of $300,000.00, and the corporate indebtedness of said corporation was increased from nothing to $400,000.00, represented by an issue of 6% debenture bonds due February 1, 1959; denies the remaining allegations of paragraph V (4) of the petition.

(5) Admits that said corporation exchanged 5,000 shares of new common stock without par value and $400,-

000.00 of principal amount of debenture bonds for the 1,000 shares of old common stock outstanding; admits that the exchange was made on the basis of 5 shares of new common stock without par value and $400.00 of debenture bonds for each share of old common stock; admits that the 1,000 shares of old common stock were then cancelled; denies the remaining allegations of paragraph V (5) of the petition.

(6) Admits that in April 1939, petitioner received in exchange for his 798 shares of $100.00 par value old common stock of J. Robert Bazley, Inc., 3,990 shares of no par new common stock of said corporation and $319,200.00 principal amount of 20-year 6% debenture bonds of said corporation; denies the remaining allegations of the first sentence of paragraph V (6) of the petition. Respondent denies that petitioner's contention made in the second sentence of paragraph V (6) of the petition is justified in law or in fact and opposes said contention; denies the allegations of the third sentence of paragraph V (6) of the petition; denies the remaining allegations and opposes the remaining contentions made by petitioner in said paragraph V (6) of the petition.

VI. Denies generally each and every allegation of the petition not hereinabove specifically admitted, qualified or denied.

WHEREFORE, respondent prays that the petition be denied.

(Sgd.) J. P. WENCHEL,
B. F.
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
HARTFORD ALLEN,
Division Counsel,
BROOKS FULLERTON,
Special Attorney,
Bureau of Internal Revenue.

STIPULATION OF FACTS.

IT IS HEREBY STIPULATED and AGREED by and between the parties hereto, by their respective attorneys, that the following statements may be taken as facts and that the same may be considered by the Court as offered in evidence by the parties to this proceeding; provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts stipulated herein:

1. The petitioners are citizens of the United States and reside in Pottsville, Pennsylvania.

2. Each of the petitioners for the calendar year 1939 filed a separate income tax return with the Collector of Internal Revenue for the First District of Pennsylvania on or before March 15, 1940. The books of each of said petitioners are kept and their respective income tax returns for the year 1939 were filed on the cash basis, except for the hauling business which J. Robert Bazley conducted as sole proprietor and which is on an accrual basis.

3. (b) The notice of deficiency dated February 11, 1943, which is addressed to petitioner J. Robert Bazley and which forms the basis of this appeal, proposes a deficiency in income tax for the year 1939 in the amount of $214,170.52.

ISSUE—*Reorganization of J. Robert Bazley, Inc.*

4. J. Robert Bazley, Inc. was incorporated under the laws of the Commonwealth of Pennsylvania on May 1, 1930, with an authorized capital of 1,000 shares of a par value of $100 per share. On February 1, 1939, and at all times hereinafter referred to, this stock was owned in the following amounts and by the following persons:

Name	Number of Shares
J. Robert Bazley	798
Alice H. Bazley	201
Alfred Day	1

all of whom, at all times herein material, constituted the Board of Directors of said corporation.

5. On February 6, 1939, at a special meeting of the Board of Directors of J. Robert Bazley, Inc. held at the principal office of the company at Port Carbon, Pennsylvania, the Board of Directors duly adopted an agreement entitled "Plan of Reorganization (Recapitalization or Reorganization)" dated as of February 1, 1939, hereinafter referred to as the Agreement. A true and correct copy of the minutes of said special meeting of February 6, 1939, of the Board of Directors of J. Robert Bazley, Inc. is attached hereto, made a part hereof, and marked Exhibit 1-A, and a true and correct copy of the said Agreement, considered and adopted is attached hereto, made a part hereof, and marked Exhibit 2-B.

6. On February 16, 1939, all the owners of the outstanding capital stock of J. Robert Bazley, Inc. held a special meeting at the office of the company at Port Carbon, Pennsylvania, and unanimously approved the said Agreement. A true and correct copy of the minutes of February 16, 1939, of the special meeting of the stockholders of J. Robert Bazley, Inc. together with a specimen form of the debenture bonds approved in said meeting is attached hereto, made a part hereof, and marked Exhibit 3-C.

7. Under the said Agreement as adopted by the directors and approved by the shareholders, the capital stock of the company was duly increased from 1,000 shares common stock of a par value of $100 per share to 5,000 shares common stock of no par value with a stated value of $300,000 and the corporate indebtedness was increased from nothing to $400,000, represented by an issue of Twenty Year Six Per Cent. Debenture Bonds of said J. Robert Bazley, Inc. due February 1, 1959.

8. On March 6, 1939, the Commonwealth of Pennsylvania approved the amendment to the company's articles

of incorporation increasing the authorized capital stock of the said corporation from 1,000 shares of common stock of a par value of $100 per share to 5,000 shares of common stock of no par value, the stated capital applicable to which is $300,000.

9. In accordance with the resolution adopted at the meeting of the shareholders of J. Robert Bazley, Inc. held on February 16, 1939, the capital structure of the company, which prior to the consummation of the terms of said Agreement, was as follows:

1,000 shares common stock of par value of $100 per share	$100,000.00
Earned Surplus	855,783.82
Total	$955,783.82

after the consummation thereof, the capital structure was changed as shown by the corporation's books of account, as follows:

5,000 shares common stock without nominal or par value, the stated capital applicable to which is	$300,000.00
Earned Surplus	255,783.82
Outstanding Debenture Bonds	400,000.00
Total	$955,783.82

10. On March 16, 1939, the stockholders of J. Robert Bazley, Inc. pursuant to the terms of said Agreement delivered to the corporation the 1,000 shares of common stock previously held by them and received therefor from the corporation the 5,000 shares of its new common stock of no par value and debenture bonds in the aggregate principal amount of $400,000, dated February 1, 1939, and due February 1, 1959. Thereupon the 1,000 shares of common stock of the par value of $100 per share previously outstanding were duly cancelled by the corporation.

12. Petitioner J. Robert Bazley on March 16, 1939, pursuant to and in accordance with the terms of the Agreement duly received for his 798 shares of $100 par value common stock of J. Robert Bazley, Inc. having a basis of $79,800 (all of which had been held by him since May 4, 1930) 3,990 shares of no par value common stock and $319,200 principal amount of Twenty Year Six Per Cent Debenture Bonds of J. Robert Bazley, Inc.

13. There is attached hereto, made a part hereof, and marked Exhibit 4-D a true and correct copy of the balance sheets of J. Robert Bazley, Inc. per books as of the beginning and end of the corporation's fiscal year ending April 30, 1939.

14. In the respective income tax returns filed by the petitioners for the calendar year 1939 neither of the petitioners reflected any taxable income or gain or deductible loss arising out of the transaction or receipt of the securities referred to in paragraphs 11 and 12, supra, on the alleged theory, which is their present contention, that no taxable income or gain or deductible loss was realized as the result of the exchange since the transaction constituted a reorganization within the provisions of Section 112 (g) of the Internal Revenue Code and that therefore no gain or loss should be recognized upon the exchange of stock of J. Robert Bazley, Inc. for stock and securities of J. Robert Bazley, Inc. in accordance with the provisions of Section 112 (b) (3) of the Internal Revenue Code.

16. The Commissioner of Internal Revenue by the Deficiency Notice increased the taxable income shown on the return of J. Robert Bazley by the amount of $319,200, explaining the adjustment as follows:

> "(a) Other income has been increased $319,200 representing the fair market value of bonds of J. Robert Bazley, Inc. received in exchange of common stock of that corporation."

17. In accordance with the terms of the Agreement J. Robert Bazley, Inc. agreed to and did pay all expenses incident to and connected with the consummation of said Agreement and agreed to and did pay all taxes, Federal and State, including stamp taxes, incident to the issuance by the corporation of the new stock and Twenty Year Six Per Cent Debenture Bonds.

18. The 5,000 shares of new common stock and the $400,000 face amount of Twenty Year Six Per Cent Debenture Bonds issued by J. Robert Bazley, Inc. to its shareholders on March 16, 1939 for the 1,000 shares of $100 par value common stock of said company had fair market values at that time of not less than $300,000 for the said 5,000 shares of common stock and $400,000 for the said debenture bonds.

FREDERICK E. S. MORRISON,
Counsel for Petitioners.

J. P. WENCHEL,
A
Chief Counsel, Bureau of Internal Revenue.

EXHIBIT 1-A.

Minutes of a special meeting of the Board of Directors of J. Robert Bazley, Inc., held at the principal office of the company at Port Carbon, Pennsylvania, on February 6th, 1939, at 10 o'clock A. M., notice of the meeting having been waived by the Directors.

There were present in person: J. Robert Bazley, Alice H. Bazley, and Alfred Day, constituting the entire Board.

Mr. J. Robert Bazley acted as chairman and Mr. Alfred Day acted as secretary of the meeting.

The chairman announced that the meeting was called to discuss the advisability of reorganizing and recapitalizing the corporation. He read to the Board a proposed Plan of Reorganization which, he suggested, in his opinion

would be advisable for the corporation to consummate. He advised the meeting that the suggested Plan had been exhaustively discussed with Roscoe Koch, Esq., counsel for the company, and with Wesley, Wagoner, Trautman & McWilliams, who were especially retained for their advice. He stated that he had moreover gone into the details at great length with the company's accountants, Wm. Reuben Lefferts & Co., and that it was the consensus of opinion of counsel and the accountants that the Plan was advantageous to the corporation and its stockholders, and that it would be to the advantage of all parties to adopt the same. The Plan was analyzed, paragraph by paragraph, by the Directors and, upon motion duly seconded, the following resolution was unanimously adopted:

RESOLVED that, in the opinion of the Board of Directors, it is to the advantage of the corporation and its stockholders that the Plan of Reorganization dated as of February 1st, 1939, be adopted; and be it further

RESOLVED that a copy of said Plan be attached to the minutes of this meeting.

The chairman stated that, in order to consummate the Plan, the charter of the corporation would have to be amended to provide for the issue of the new no par value common stock and that the corporate indebtedness of the company would have to be increased to provide for the issuance of the Debenture bonds contemplated by the Plan, all of which require the action of the stockholders.

Upon motion, duly seconded, the following resolution was unanimously adopted:

RESOLVED that the formal corporate indebtedness of this company be increased from nothing to $400,000.00;

RESOLVED that a meeting of stockholders be called to convene at the general office of the company on the 16th day of February, 1939, to take action on approval or disapproval of the proposed increase of the formal indebtedness of this company, the notice required to be given by the Constitution and laws of this Commonwealth having been waived by the unanimous consent of the stockholders.

Upon motion, duly seconded, it was unanimously

RESOLVED that paragraph 7th of the Articles of Incorporation of this corporation be amended so as to read as follows:

The authorized capital stock of the corporation is 5,000 shares of common stock without par value, the stated capital applicable to which is $300,000.00.

RESOLVED FURTHER that a meeting of stockholders be called to convene at the general office of this company on the 16th day of February, 1939, to take action on approval or disapproval of the proposed amendment, the notice required to be given by the Constitution and laws of this Commonwealth having been waived by the unanimous consent of the stockholders.

Upon motion, duly seconded, it was unanimously

RESOLVED that Charles Shuster, Russell Hershberger, and Richard Evans be and they hereby are appointed judges of election to act as such at the meeting of stockholders to be held on February 16th, 1939, or any adjournment thereof.

There being no further business before the meeting, the same adjourned.

(Signed) Alfred Day
Secretary.

APPROVED:

S/ J. Robert Bazley
S/ Alice H. Bazley
S/ Alfred Day

EXHIBIT 2-B.

J. ROBERT BAZLEY, INC.

PLAN OF REORGANIZATION

DATED AS OF FEBRUARY 1, 1939

PRESENT CAPITALIZATION

As of February 1st, 1939, the corporation's capitalization is as follows:

1,000 shares of common capital stock of the par value of $100.00 per share	$100,000.00
Earned surplus	855,783.82
Total capital and surplus	$955,783.82

RECAPITALIZATION OR REORGANIZATION

The corporation shall reorganize its capital structure, as of February 1st, 1939, by the issuance of 5,000 shares of common capital stock of no par value (with a stated value of $300,000.00), earned surplus of $255,783.82, and $400,000.00 principal amount of six per cent. debenture bonds, the terms and provisions of which are as hereinafter stated.

The corporation shall issue, in exchange for the 1,000 shares of present outstanding common stock, 5,000 shares of the new common stock without par value and $400,000.00 principal amount of debenture bonds. Upon said exchange, the present outstanding common stock shall be cancelled so that, upon the consummation thereof, the capitalization of the company shall consist of 5,000 shares of common stock, without par value, the stated capital applicable to which is $300,000.00, earned surplus $255,783.82, and the corporation shall be subject to $400,000.00 principal amount of outstanding debenture bonds.

TERMS OF THE DEBENTURE BONDS

The debenture bonds will be limited to the aggregate principal amount of $400,000.00. They will be issuable in registered form only, without coupons, in denominations of $100.00 and any multiple of $100.00. They will be dated as of February 1st, 1939, which is the effective date of the reorganization, and will be payable February 1st, 1959. The debenture bonds will be callable, as a whole or in part, at any time on thirty days' notice at the principal amount thereof plus all accumulated and unpaid interest to the date of redemption. The corporation will pay, on April 30th of each year, beginning April 30th, 1939, interest upon the debenture bonds at the rate of six per cent. per annum, and the corporation will assume and pay the personal-property tax, not exceeding eight mills on the dollar, assessed against the holders of the bonds under the laws of the Commonwealth of Pennsylvania.

EFFECTIVE DATE OF REORGANIZATION

The effective date of the reorganization shall be February 1st, 1939. The exchange of securities as provided in the Plan shall be made at the office of the company at Port Carbon, Schuylkill County, Pennsylvania, within fifteen days from the approval of the reorganization by formal action of stockholders and by the Commonwealth of Pennsylvania's approval of the Amendment to the Articles of Incorporation.

The corporation will bear all expenses incident to and connected with the consummation of the Plan and will pay all taxes, federal and state, including stamp taxes incident to the issuance of the new stock and securities.

The corporation has hereunto affixed its corporate seal, duly attested, and the individual stockholders have caused their hands and seals to be affixed, indicating their several

and respective approvals of the aforesaid Plan, as of February 1st, 1939.

J. ROBERT BAZLEY, INC.,
By J. Robert Bazley
President

Attest: Alfred Day
Secretary

(Corporate Seal)

J. Robert Bazley
Alice H. Bazley
Alfred Day

EXHIBIT 3-C.

Minutes of a special meeting of the stockholders of J. Robert Bazley, Inc., held at the office of the company at Port Carbon, Pennsylvania, on February 16th, 1939, at 10 o'clock A. M., notice of the meeting having been waived by the unanimous consent of the stockholders.

There were present in person the following: J. Robert Bazley, Alice H. Bazley, and Alfred Day, constituting the owners of all the outstanding capital stock.

Mr. Bazley acted as chairman and Mr. Day as secretary of the meeting.

The chairman announced that the meeting was called in accordance with the resolutions adopted by the Board of Directors at their meeting on February 6th, 1939, to take formal action approving a proposed Plan of Reorganization of the company dated as of February 1st, 1939, and the consequent increase of the formal corporate indebtedness and proposed amendment to the Articles of Incorporation of the company.

Upon motion, duly seconded, it was unanimously

RESOLVED that the Plan of Reorganization dated as of February 1st, 1939, a copy of which is attached to the min-

utes of the meeting of the Board of Directors held February 6th, 1939, be and the same hereby is approved.

Upon motion, duly seconded, the following resolution was proposed:

RESOLVED that the formal corporate indebtedness of this company be increased from nothing to $400,000.00, said indebtedness to be represented by an issue of the company's six per cent. debenture bonds, the terms and provisions of which are more particularly set forth in said bonds, the form of which is hereby approved and a copy thereof attached to the minutes of this meeting.

The judges appointed by the Board of Directors took the vote on the above resolution and reported that there were voted in favor thereof 1,000 shares and thereagainst no shares.

The chairman thereupon announced that the resolution was adopted, and it was directed that the Judges' Return and the Waiver of Notice of the meeting executed by all the stockholders be attached to the minutes of this meeting.

Upon motion, duly seconded, the following resolution was proposed:

RESOLVED that paragraph 7th of the Articles of Incorporation of this corporation be and the same is hereby amended so as to read as follows:

> The authorized capital stock of the corporation is 5,000 shares of common stock without par value, the stated capital applicable to which is $300,000.00.

The judges appointed by the Board of Directors took the vote on the above resolution and reported that there were voted in favor thereof 1,000 shares and thereagainst no shares.

The chairman thereupon announced that the resolution was adopted, and it was directed that the Judges' Return and the Waiver of Notice of the meeting executed by all of the stockholders be attached to the minutes of this meeting.

Upon motion, duly seconded, it was

RESOLVED FURTHER that the president and secretary of the corporation be and they are hereby authorized, empowered, and directed to execute under the corporate seal of this corporation Articles of Amendment to the Articles of Incorporation and to file such Articles of Amendment with the Department of State of the Commonwealth of Pennsylvania.

On motion, it was directed that the said amendment be duly advertised.

The president stated that, should the amendment just adopted be approved by the Commonwealth of Pennsylvania, the company would immediately take steps, in accordance with the terms of the Plan of Reorganization, to issue the new common stock and the debenture bonds in exchange for the present outstanding common stock in the ratio of five shares of new common stock and $400.00 principal amount of debenture bonds in exchange for each share of the present outstanding common stock, and that upon the consummation of said exchange, the present common stock now outstanding would be cancelled. He stated that a formal resolution directing such exchange and the consequent reorganization of the corporation's capital structure was in order.

Upon motion, duly seconded, the following resolution was unanimously adopted:

RESOLVED that, upon the approval by the Commonwealth of Pennsylvania of the amendment to the company's Articles of Incorporation, the proper corporate officers shall take immediate steps to consummate the reorganization of the company in accordance with said Plan of Reorganization dated as of February 1st, 1939, and shall forthwith execute and deliver the 5,000 shares of the new non par value common stock and $400,000.00 principal amount of debenture bonds in exchange for the common stock now outstanding, consisting of 1,000 shares of the par value of $100.00 a

share, and that when said exchange has been completed, the present outstanding common stock be forthwith cancelled; and be it further

RESOLVED that the capital structure of the company, which as of February 1st, 1939, is as follows:

1,000 shares of common capital stock of the par value of $100.00 per share	$100,000.00
Earned surplus	855,783.82
Total capital and surplus	$955,783.82

be, upon the consummation of the said Plan of Reorganization, changed as of February 1st, 1939, so that it shall be as follows:

5,000 shares of common capital stock without nominal or par value, the stated capital applicable to which is	$300,000.00
Earned surplus	255,783.82
Outstanding debenture bonds	400,000.00
	$955,783.82

and be it further

RESOLVED that the company's accountants be directed to make the proper entries in the books and records of the company showing the reorganization as above set forth.

The chairman presented a form of common stock certificate proposed to be issued and, on motion duly seconded, it was unanimously

RESOLVED that the form of common stock certificate presented to the meeting be and the same hereby is approved and adopted.

Upon motion, duly seconded, it was unanimously

RESOLVED that the treasurer of the corporation be and he hereby is authorized and directed, on behalf of the cor-

poration, to cause the due registration of the debenture bonds hereinabove authorized and, as such registrar, to execute such papers and documents as may be required.

There being no further business before the meeting, the same adjourned.

Alfred Day
Secretary.

J. Robert Bazley, Inc.
Waiver of Notice

To the Directors of J. Robert Bazley, Inc.:

We, the undersigned, constituting the owners of all the outstanding capital stock of J. Robert Bazley, Inc., who are the holders of said stock to the amounts set opposite our several names, request that you, by resolution, declare that it is the desire of the corporation to increase its formal corporate indebtedness from nothing to $400,000.00, and to amend its Articles of Incorporation so as to increase the capital stock from 1,000 shares of the par value of $100.00 per share to 5,000 shares without nominal or par value, the stated capital applicable to such non par value shares to be $300,000.00. And we request that you, by resolution, call a meeting of the stockholders of the company to be held on the 16th day of February, 1939, for the purpose of voting for said increase in corporate indebtedness and said amendment to the Articles of Incorporation. And we do hereby waive the notice of such meeting of the stockholders, required to be given by the 7th section of the 16th Article of the Constitution of Pennsylvania, and by the laws thereof relating to the increase of capital stock or indebtedness of corporations, as well as by any by-law of the company requiring notice of such meeting to be given:

Name	No. of Shares
J. Robert Bazley	798
Alice H. Bazley	201
Alfred Day	1

COMMONWEALTH OF PENNSYLVANIA }
COUNTY OF PHILADELPHIA } ss.

ALFRED DAY, being duly sworn according to law, doth depose and say that he is secretary of J. Robert Bazley, Inc., that the stock ledger of said company is in his custody and under his control, and that the list of stockholders given in the above waiver of notice of a meeting to be held for the purpose of voting for or against the increase of the formal corporate indebtedness of the company and for the amendment to its Articles of Incorporation, is a complete list of such stockholders, that they are the owners of the entire issue of the stock of said company, and that the signatures to said waiver are genuine and in the proper handwriting of the subscribers.

Alfred Day
Secretary.

Sworn to and subscribed before me, this 16th day of February, A. D., 1939.

Jane L. Sheldon (SEAL)
JANE L. SHELDON
1000 Packard Bldg.
NOTARY PUBLIC
My Commission Expires March 2, 1941.

JUDGES' RETURN

We, the undersigned judges, appointed by the Board of Directors of J. Robert Bazley, Inc., to conduct an election by the stockholders thereof, for or against an increase of the formal corporate indebtedness of the company from nothing to $400,000.00, do hereby certify that we held the election on the 16th day of February, 1939, at the office of said company, the time and place fixed for holding the same, of which sixty days' previous notice by publication was duly waived, and in due form and manner we received the votes of the stockholders of the said company in favor of or against such increase; and at the said election there were

voted in favor of such increase 1,000 shares and against such increase no shares, thereupon evidencing the consent of the persons holding the larger amount in value of the capital stock of said company to the said increase.

Charles J. Schuster
Russell L. Hershberger
Richard W. Evans

JUDGES' RETURN

We, the undersigned judges, appointed by the Board of Directors of J. Robert Bazley, Inc., to conduct an election by the stockholders thereof, for or against an increase of the capital stock of the company from 1,000 shares of the par value of $100.00 per share to 5,000 shares without nominal or par value, the stated capital applicable to said non-par value shares to be $300,000.00, do hereby certify that we held the election on the 16th day of February, 1939, at the office of said company, the time and placed fixed for holding the same, of which sixty days' previous notice by publication was duly waived, and in due form and manner we received the votes of the stockholders of the said company in favor of or against such amendment; and at the said election there were voted in favor of such amendment 1,000 shares and against such amendment no shares, thereupon evidencing the consent of the persons holding the larger amount in value of the capital stock of said company to the said amendment.

Charles J. Schuster
Russell L. Hershberger
Richard W. Evans

UNITED STATES OF AMERICA
COMMONWEALTH OF PENNSYLVANIA

J. Robert Wazley, Inc.

Twenty Year Six Per Cent. Debenture

Due February 1st, 1959

Authorized Issue, $400,000.00

J. Robert Wazley, Inc., *a corporation duly organized and existing under the laws of the Commonwealth of Pennsylvania (hereinafter called the "Corporation"), for value received, hereby promises to pay to the registered holder hereof, on the first day of February, 1959,*

.....Dollars ($.....),

in coin or currency which at the time of payment is, under the laws of the United States of America, legal tender for public and private debts, at the office of the Corporation at Port Carbon, Pennsylvania, and to pay interest on said sum from February 1st, 1939, in like coin or currency, at said office, at the rate of six per cent. per annum on April 30th in each year until maturity, without deduction therefrom for any taxes assessed against the holders of said debentures by reason of their ownership thereof as provided by the laws of the Commonwealth of Pennsylvania (other than income, succession, estate, and inheritance tax laws), and the corporation agrees to pay such taxes, not exceeding, however, eight mills per annum on each dollar of the principal amount hereof. This debenture is one of a duly authorized issue of debentures of the Corporation aggregating the principal amount of $400,000.00, all of said debentures being of like tenor, date, and effect.

All said debenture bonds are subject to redemption, as a whole or in part, on any interest paying date prior to maturity, upon the payment of the principal sum thereof and accrued interest, at the election of the Corporation, its successors or assigns, by giving thirty days' written notice of its election to redeem to the registered holders thereof.

If the debentures are called for redemption and payment duly provided, the debentures shall cease to bear interest from and after the date fixed for such redemption.

interest from and after the date fixed for such redemption.

The debentures are issuable in denominations of $100.00 or any multiple of $100.00.

This debenture is a fully registered debenture and is transferable by the registered holder hereof in person or by the duly authorized attorney or representative of such holder on the registration books to be kept for the purpose at the principal office of the Corporation, upon surrender of this debenture accompanied by a written instrument of transfer in form approved by the Corporation, duly executed by the registered holder in person or by such attorney or representative, and such transfer noted hereon, or upon cancellation hereof one or more new fully registered debentures of the same aggregate principal amount will be issued to the transferee in exchange therefor. The Corporation may treat the person in whose name this debenture is registered on such books as the absolute owner hereof for the purpose of receiving payment of or on account of the principal hereof and interest due hereon and for all other purposes, and the Corporation shall not be affected by any notice to the contrary.

As a condition precedent to any interchange, exchange, or transfer referred to above, the Corporation may require payment by the holder of a sum sufficient to reimburse it for any stamp tax or any other governmental charge with respect to any transfer involved therein.

No recourse shall be had for the payment of the principal or interest on this debenture, or for any claim based hereon or otherwise in respect hereto against any incorporator or any past, present, or future stockholder, officer, or director of the Corporation, or any successor corporation, all such liability being by the acceptance hereof expressly waived and released.

In Witness Whereof, J. ROBERT BAZLEY, INC., has caused this debenture to be signed by its President and its corporate seal to be hereto affixed and to be attested by its Secretary, this 1st day of February A. D. 1930.

J. Robert Bazley, Inc.

By _____ President

Attest:

Secretary

BROWN-GREEN CO. NEW YORK

© THE BROWN-GREEN CO 48 JOHN ST N Y 14

REGISTRY AND ENDORSEMENT

DATE OF REGISTRY	NAME & ADDRESS OF REGISTERED OWNER	COUNTERSIGNED BY

SPECIMEN
BROWN-BRETT CO
NEW YORK

32a

J. Robert Bazley.
Inc.

6 PER CENT

$_____

TWENTY YEAR

DEBENTURE

PRINCIPAL DUE

February 1st, 1959

INTEREST PAYABLE

Annually on April 30th

EXHIBIT 4-D

J. ROBERT BAZLEY, INC.
SCHEDULE I
COMPARATIVE STATEMENT OF ASSETS AND LIABILITIES
AT APRIL 30, 1939 and APRIL 30, 1938

ASSETS

	April 30, 1939		April 30, 1938	
Current				
Cash		$120,964.87		$154,675.29
Accounts Receivable	270,540.47		269,719.99	
Less				
Reserve for Bad Debts	66,895.24		51,977.35	
		203,645.23		217,742.64
Investments at Cost				
U. S. Securities (Sched. III)	27,268.32		—	
Bonds (Sched. III)	166,010.61		36,614.31	
Stocks (Sched. IV)	83,943.48		54,068.51	
		*277,222.41		*90,682.82

Exhibit 4-D of Stipulation

339

J. Robert Bazley—Personal		—		868.95
Corporate Loans Tax—F. Y. 1936		47.50		—
Total Current Assets		601,880.01		463,969.70
Fixed				
Plant and Equipment	719,782.41		823,498.72	
Less Reserve for Depreciation	375,823.09		387,596.07	
Total Fixed Assets		343,959.32		435,902.65
Compensation Insurance Deposit		3,000.00		3,000.00
Charter Fees		387.50		387.50
Goodwill		10,000.00		10,000.00
Total Assets		959,226.83		913,259.85
LIABILITIES				
Current				
Vouchers Payable		34,596.43		33,163.76
Royalties Payable		—		3,672.00
Accrued Wages		13,246.89		14,137.54
Accrued Compensation Insurance		1,887.74		1,627.69

Exhibit 4-D of Stipulation

Retained Money—Truckers		1,018.06		500.00
Federal Old Age Benefits Tax		715.78		342.14
Unemployment Insurance Tax		1,931.24		1,497.38
Reserve for State and Federal Taxes		36,232.50		22,429.52
Total Current Liabilities		89,728.64		77,370.03
Debenture Bonds Payable		400,000.00		—
Total Liabilities		489,728.64		77,370.03
Deferred Credits		—		569.75
		489,728.64		77,939.78
NET WORTH				
Capital Stock	300,000.00		100,000.00	
Surplus	169,498.19		735,320.07	
		469,498.19		835,320.07
		$959,226.83		$913,259.85

Exhibit 4-D of Stipulation

* Subject to shrinkage in value of investments of $18,615.00 at April 30, 1939 and $25,789.07 at April 30, 1938.

CORRECTED TRANSCRIPT OF PROCEEDINGS.

[57] Court Room No. 2,
Federal Building,
Philadelphia, Pennsylvania,
September 12, 1944—10 A. M.

(Met pursuant to notice.)

Before Honorable Clarence V. Opper, Judge.

Appearances:

Frederick E. S. Morrison, Esq., and Calvin H. Rankin, Esq., 1429 Walnut Street, Philadelphia, Pa., appearing on behalf of Alice H. Bazley and J. Robert Bazley, Petitioners.

W. J. McFarland, Esq. (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the Commissioner of Internal Revenue, Respondent.

[58] PROCEEDINGS.

The Court: Will you call the calendar.

The Clerk: Docket Nos. 1520 and 1521, Alice H. Bazley and J. Robert Bazley.

Mr. Morrison: Ready for the petitioner.

Mr. McFarland: Ready for the respondent.

Mr. Morrison: Frederick E. S. Morrison and Calvin H. Rankin.

Your Honor, I have handed to the Clerk a motion to consolidate these two cases as they involve the same issue.

The Court: Are you Mr. Morrison.

Mr. Morrison: Yes.

The Court: Any objection?

Mr. McFarland: No objection.

THE COURT: Motion will be granted. The cases will be consolidated for hearing and consideration.

OPENING STATEMENT ON BEHALF OF THE PETITIONER.

BY MR. MORRISON.

MR. MORRISON: If Your Honor please, the issue in this case is that the Commissioner has proposed a 90-day letter claiming the existence of deficiencies in tax, income tax, arising out of a transaction which we allege to be a reorganization inasmuch as it was a recapitalization of the corporation known as J. Robert Bazley, Inc., a Pennsylvania corporation.

[59] In 1939, the spring of that year and late winter—that is, I am talking about February and March—the corporation by its directors and stockholders, duly adopted a plan of reorganization by which its then outstanding stock of 1,000 shares of common stock of the par value of $100 each was exchanged for $400,000 face amount of debenture bonds, 6 per cent 20-year debenture bonds, and 5,000 shares of no par value common stock having a stated capital of $300,000. That exchange was made with the stockholders and the old stock cancelled, and thereupon, the capital of the corporation, previously represented by $100,000 of common stock and some $800,000 of surplus, was converted into 300,000 of capital stock, 400,000 of bonds, and I think some 200,000 of surplus.

The Commissioner, in his 90-day notice, in making the determination that these petitioners here had realized a profit or a gain, states, and I quote from the Commissioner's 90-day letter:

> "A. Other income has been increased $80,400, representing the fair market value of bonds of J. Robert Bazley, Inc., received in exchange of common stock of that corporation. It is held that in this transaction you received income of $80,400, which is taxable in your return for the year 1939."

That was so stated in the 90-day letter to Alice [60] H. Bazley, and similarly, it was so stated in the 90-day letter issued to J. Robert Bazley, except that the amount of $80,400 was changed or was made to read $319,200.

Now, it is the contention of the petitioners that this was a tax-free reorganization under Section 112-B (3) and G of the Internal Revenue Code—in fact, I think it was the Revenue Act of 1938 at that time—and that no gain or loss was realized or to be recognized to either one of them.

That is the substance of our position.

THE COURT: Do I understand that as far as the receipt of the common stock is concerned, that there is no controversy?

MR. MORRISON: No controversy whatsoever—at least the Commissioner has never said so. All he says that on the exchange of the bonds for the stock, income arises in the full amount of the fair market value of the bonds, without ascribing—and I want to point that out while you mention it. He fails to do two things. He ascribes no value or no basis to the old stock in computing the portion of the bonds that he alleges to be taxable, and the second thing he does——

THE COURT: Will you state that again, please?

MR. MORRISON: The Commissioner, in his 90-day letter, failed, assuming that there is a taxable transaction on the exchange of bonds for stock, although we do not [61] admit that for one second—he allocates no part of the basis of the stocks given up by the stockholders to those bonds in arriving at the amount of gain realized by these petitioners.

THE COURT: Do you say he should?

MR. MORRISON: Yes, that is, if it is a taxable exchange.

THE COURT: Well, suppose his position is that the stock, that the new stock that was issued to the petitioners is what carries the basis?

Mr. Morrison: I don't see how he can. In his 90-day letter he recognizes an exchange, and he says, "In exchange for the stock you got from the corporation bonds."

Now, he also knows that they got stock from the corporation. That is stipulated. We will offer that in a minute.

Now he says, on that exchange, reading from the 90-day letter—I don't know whether Your Honor wants it taken down:

> "Other income has been increased $319,000, representing the fair market value of bonds of the J. Robert Bazley, Inc., received in exchange of common stock of that corporation."

Now, any taxable exchange requires that the thing given up, the basis of the thing given up, must be applied [63] against the value of the thing received, and gain or loss realized and recognized, but he doesn't say that. He doesn't give us any credit or an allocation of the basis there.

The other thing is this. That he fails to recognize, although the stipulation clearly shows it, that this stock was held for more than 24 months. Therefore, it is not permissible under the law to recognize in the so-called taxable exchange, anything but 50 per cent. of the proper amount of gain, and then to tax that as a maximum of 30 per cent. under the capital gain rate.

The Court: Now, I notice that there is a small item referred to in the deficiency notice. It is unallowable deduction. I take it there is no issue as to that, is that right?

Mr. Morrison: I doubt it. Oh, yes, we are not bothering with that.

The Court: Thank you.

OPENING STATEMENT ON BEHALF OF THE RESPONDENT.

By Mr. McFarland.

Mr. McFarland: If the Court please, these dockets involve deficiencies in income tax liabilities for the year 1939 of J. Robert Bazley and his wife, Alice H. Bazley, in the respective amounts of $214,170.52 and $35,734.49.

The issue in both cases arises by the action taken [63] on the part of the respondent whereby he included in the taxable income of both petitioners for the year 1939 the face value of the bonds of J. Robert Bazley, Inc., received by each petitioner pursuant to the terms of the so-called plan of reorganization.

The respondent contends that the exchange by the petitioners of stock—that is, for stock and debenture bonds pursuant to a plan of reorganization of J. Robert Bazley—and the plan, I believe, bore the date of February 1, 1939—does not come within the applicable provisions of the Internal Revenue Code or the Revenue Act of 1938, which I believe was in effect then, but rather represents a distribution of a dividend to the extent of the accumulated earnings after February 28, 1913.

The plan provided, or rather, the transaction involved 1,000 shares of common stock, having a par value of $100 per share, and they were surrendered by the shareholders who received therefor 5,000 shares of no par common stock plus corporate 20-year 6 per cent. debenture bonds with a face value of $400,000, which increased the corporate indebtedness from nothing to $400,000 thereby.

The respondent contends that the structural change here made does not meet and thus fails to satisfy the requirements of the term "recapitalization" as used in Section 112 (g) (1) (E) of the Code, of the Internal Code, in that it was not motivated by legitimate business purposes [64] and was not necessary to and did not, in fact, strengthen the financial structure of the corporation, and that that which was accomplished was essentially equiva-

ient to the distribution of a taxable dividend by the corporation, and I would like to cite at this time the remarks of the Court, the Tax Court in the case of Arthur J. Hooks and W. J. Norton, Docket 109,416 and 109,427, which was decided on August 22 of this year by the Court, and it is set forth in the body of the Court's opinion.

"There are three tests, namely,

"A. That it be motivated"—that is, the reorganization—"by legitimate business purposes.

"B. That it be necessary to strengthen the financial structure of the corporation, and

"C. That as a result of the recapitalization, the stockholders have substantially the same interest in the corporation as before."

THE COURT: Aren't you allowing yourself to be confused by the position of the petitioner? You keep talking about an exchange here, and Mr. Morrison properly points out that if you exchange something, you have got to take into consideration what you are exchanging.

As I understand your statement now, what you say is, assuming that the common stock was an exchange, that the [65] delivery of the bonds was the distribution, was the equivalent of a dividend, and therefore taxable and not only taxable in full and without any reduction of the basis, but taxable as ordinary income and not as capital gain.

Isn't that your position?

MR. MCFARLAND: That is our position.

THE COURT: Then you don't really mean that those bonds were exchanged for anything?

MR. MCFARLAND: No, we haven't admitted that the bonds were exchanged for anything.

THE COURT: It isn't a question of admitting; you keep talking about an exchange. I just want to be sure that there isn't any misapprehension as to your position.

As I get it now, what you say is that, assuming that there was an exchange of stock for stock, that the addition in that transaction of the bonds was a distribution by the corporation and it was the equivalent of a taxable dividend, is that right?

MR. MCFARLAND: That is our position.

THE COURT: And even though the petitioner may say that the whole thing was an exchange, a taxable exchange, you take the position that as far as the bonds are concerned, there was no exchange at all, is that right?

MR. MCFARLAND: That is correct.

THE COURT: I think it is going to be important [66] for us to try to keep these positions in mind here, not only now, during the hearing, but also, more important, when you come to filing your briefs.

MR. MCFARLAND: Very well.

THE COURT: Do you have something more you wanted to say?

MR. MORRISON: Just this, Your Honor. I don't see how, when this court and the Circuit Court of Appeals and the Supreme Court have said you have got to look at the transaction as a whole, how you can put a knife through and say you are going to recognize this, as an exchange of stock solely for stock. Truly, you had an exchange of stock for stock on the one part, but also an exchange of bonds for stock, because 1,000 shares of stock went back to the corporation, was cancelled, and in exchange for that, out flowed 5,000 shares of common stock and the debenture bonds, all in the same transaction.

THE COURT: You are not suggesting, are you, that a taxpayer could create something which he called a plan of reorganization and, in connection with that, he could make an exchange of two essentially synonymous articles and then, by the distribution either of taxable stocks or bonds

or property or of cash, could so tie up the two things that that distribution would be non-taxable?

MR. MORRISON: Oh, no, because there you have that covered very well by the statute in 112-C as——

[67] THE COURT: Yes, that is the other property provision. But as I understand it, it says the bonds are the equivalent of other property.

MR. MORRISON: Oh, but he can't under that section. He can't say under the section 112 (c) (1) and (2), that the bonds constitute other property.——

THE COURT: Well, you put words in his mouth.

MR. MORRISON (Continuing): —because if he does, he starts off with the premise that there was a reorganization.

THE COURT: But suppose he says to me, "I don't care if there was a reorganization."

MR. MORRISON: Then he has got to take it out of the reorganization provisions, and there is no way that he can do that.

THE COURT: He has already suggested a way.

MR. MORRISON: Not a way in accordance with the statutes, sir.

THE COURT: Of course, this is put on the statute by the decided cases. I am not going to let you come in here and talk about the statute as though Gregory against Helvering had never been defined.

MR. MORRISON: What Gregory and Helvering says is that the transaction grows out from 112-B, and all the cases that have been decided where they have said, "Well, where you have had a reorganization——"

[68] THE COURT (Interposing): Isn't that what the respondent is saying here?

MR. MORRISON: No, as I understand his position he says "the exchange of stocks is all right. We have no quarrel

with that, although the stock was increased from $100,000 of value to $300,000 stated value. I am not quarreling with that. I don't mind that surplus was changed to accomplish that just as it would be accomplished in a stock dividend. What I quarrel with and object to is that the corporation issued these 20-year debenture bonds which I recognize are securities of the corporation."

THE COURT: You are the fellow who says there was a reorganization. Why does the respondent have to take a position on that one way or the other? Suppose he says to me, "I don't care if there was a reorganization or not."

MR. MORRISON: But he didn't say that.

THE COURT: Well, I am not going to hold him to a particular type of language here. He asked me, as I understand his opening statement, to concentrate on these bonds.

MR. MORRISON: That is right.

THE COURT: Now, we are not saying anything about the stock, and I suppose it is possible for him to say, "Maybe the petitioner is getting away with something."

MR. MORRISON: Wait a minute, Your Honor. I don't think that any Court or any member of the Government should ever infer that a taxpayer is getting away with anything. I [69] think it is too serious an implication.

THE COURT: Well, now, you have misunderstood me, because what I meant—and I think if you keep your mind open a minute you will see that is what I meant—was that the respondent was suggesting that perhaps he should have taxed the petitioner on the stock.

MR. MORRISON: I think he should——.

THE COURT: And to that extent the petitioner is getting away with something, but he says, "Even assuming that I did not have to tax that, even assuming that the petitioner is entitled to look on the stock as an exchange on which the tax would be postponed—and I am not taking a position on that one way or the other," says the respondent, "never-

theless, the bonds are a distribution either because there was no reorganization at all—and, of course, in that case, the stock would have been included too—or because, assuming that there was a reorganization as far as the stock is concerned, the bonds are the property.

MR. MORRISON: Yes. But, Your Honor, please, I did not finish what I started to say—If he says the receipt of the bonds constitutes a taxable exchange, he has got to say that the stock constitutes a taxable exchange.

THE COURT: Suppose he says that. You cannot come in here and complain because he is not taxing you, because I [70] don't know what the facts are, the basis is higher than the market value of the stock, but assuming that there was a taxable gain on that exchange, you are in no position to complain because he isn't taxing you on that.

MR. MORRISON: But I have a complaint to make on the rates he applies on even a small part of the gain, so called.

THE COURT: I agree with you, but no complaint with respect to what he doesn't tax.

MR. MORRISON: No. I say this: that if he says that this is a transaction coming under 112-B, as to the stock, it is free, but as to the bonds, it is taxable, he must prove that position and state to you clearly what he means by it because he will find nothing in the statute to support him on that proposition. He has got to take the whole transaction out of 112-B and put it into 112-A, or some other section, but he cannot leave it in 112-B in any part or any degree. That is my position, and I think he should answer you as to just what his position is, because the 90-day letter, the only thing the taxpayers can look to as to why Commissioner has any idea about a thing, says, "We are going to tax you on $80,000 in one case, $319,000 in the other, on the ground that you received income when you received bonds for stock."

Now, that is an inaccurate statement. They could have said, "We are taxing you on the bonds."

[71] THE COURT: Well, the reason I asked Mr. McFarland as specifically as I did for a statement of the position now is precisely what you suggest. I understand he now says, as far as the bonds are concerned, there is not any exchange at all.

MR. MORRISON: All right.

THE COURT: And I think I asked him several times to be absolutely certain.

MR. MORRISON: But I think, in fairness to the petitioners, Your Honor, he should state it more clearly, because I don't think that this Court or the Circuit Court of Appeals or the Supreme Court will allow you to carve a transaction into several parts.

They have said, "No, you start at the beginning and look at the end, and what happens in between is just part and parcel of one whole transaction. We are not going to say that there are two reorganizations or a sale and an exchange."

THE COURT: I think you will find a number of cases—and I wouldn't be able to put my finger on them—but I think you will find there are cases which fail to apply that rule to this particular type of situation, namely, where something has the aspect of a dividend, or where the Commissioner has contended it is a dividend, and I think that that is a situation where they have cut off the exchange and dealt with the [72] other property.

MR. MORRISON: Yes, but I would like the Commissioner to state to you in open court just what sections of law apply to this case, in his judgment, because I think it will clarify the issues and help us and help the Court to understand what the case is all about.

THE COURT: I am not going to ask him to do that, but I will do this. If you get to the point where there is evidence that you propose to submit which you will have to deal with differently, depending on how the Commissioner

takes his position, I will ask him to do that then, but I want to be sure how it makes any difference to you.

MR. MORRISON: Very well, I will appreciate that.

Now, I offer in evidence stipulations of fact entered into by the respondent's counsel and petitioners' counsel.

THE COURT: You will need an original and two copies.

MR. MORRISON: I have given them to her.

THE COURT: The stipulation will be received.

MR. MORRISON: Mr. Bazley, will you take the stand, please?

Whereupon, JAMES ROBERT BAZLEY, called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

[73] DIRECT EXAMINATION.

By MR. MORRISON:

Q. Mr. Bazley, please state your full name.

A. James Robert Bazley.

Q. And what is your occupation?

A. Contracting engineer, president, treasurer of J. Robert Bazley, Inc.

Q. What are your qualifications as contracting engineer? What has been your experience—education and experience?

A. A graduate of mechanical engineering from the University of Michigan. I have had in the mechanical engineering field some 33 years of experience in mining engineering.

Q. Are you a consultant engineer?

A. Yes, sir.

Q. When were you last consulted?

A. During the last seven months I have been consultant for the British Ministry of Works in England, just having returned from there two weeks ago—three weeks ago.

Q. Were you consulted over there on mining engineering problems?

A. Yes, I was asked to go over there to develop a quick coal in the Allied war.

Q. And, you say, by the British Ministry?

A. By the British Ministry of Works, on recommendation from the industry in this country.

[74] Q. What do you mean by "the industry in this country"?

A. The coal industry.

Q. Is your corporation allied with the coal industry?

A. Our corporation removes the overburden from coal, and by a method known as the open pit mining, the coal is recovered 100 per cent by this method. It is a very quick method of obtaining coal, and that was the reason for wanting to develop this quick coal in England for the Allied invasions.

Q. Does your corporation have mines of its own?

A. We have no mines, no.

Q. Well, then, this work that you do for the coal companies—is that under contract?

A. It is all under contract, yes, sir.

Q. Well, discuss briefly, if you will, sir, the business of J. Robert Bazley, Inc.

A. J. Robert Bazley, Inc., is incorporated under the laws of Pennsylvania.

Q. Well, that has all been stipulated. Just tell us about your business.

A. Our charter is rather broad. We have the privilege, the right to any heavy type of excavation, concrete, railroad work, concreting, building railroads.

As I have already said, we mine coal by the open pit method, build highways, a general contracting business, heavy contracting.

[75] Q. Who are the officers of your corporation, please?

A. I am president-treasurer. Mrs. Bazley is vice-president. Mr. Alfred Day is secretary. Mr. Russell Hershberger is assistant treasurer.

Q. Now, Mr. Bazley, we have stipulated—and, by the way, have you read this stipulation?

A. Yes, I have read it.

Q. We have stipulated the facts, or some of the facts pertaining to the issue, namely, reorganization and recapitalization of your company, J. Robert Bazley, Inc., and that briefly shows that your capital structure was, prior to about February 1, 1939, $100,000 of common stock comprising 1,000 shares of a par value of $100 each, and a surplus of $855,000, or a total of $955,000, and that the plan of recapitalization was voted by the directors and stockholders whereby the common was increased from $100,000 to $300,000 stated value, comprising 5,000 shares of no par value, and the indebtedness was increased from nothing to $400,000, and it was upon the consummation of the plan represented by 20-year 6 per cent debenture bonds of that corporation, and that new stock, 5,000 shares of new common and the $400,000 face amount of new bonds, was issued by the corporation in exchange for the outstanding shares of stock—that is, comprising 1,000 shares of $100 each, and the stockholders turned in their old stock, and that was retired and received in exchange for the new stock [76] and the new bonds.

Q. Now, tell the Court please, what prompted the directors and the stockholders to propose and vote for this plan of reorganization.

A. Well, the management—that is, the officers and superintendent and assistant treasurer, in the discussion felt that it was advisable—or at least it seemed advisable—to try to sell stock to the key employees—that is, superintendents, engineers and foremen, and we stated a plan that would be adaptable, would be suitable for this purpose. And it seemed for that purpose, for the purpose of selling stock to the officers and superintendents and other key men, in order that they might have a financial stake in the company, that it would be advisable to reduce the value of the stock in some way so as to increase their share in the company at the time that this plan went into effect, so we hit upon this plan of stock and debenture bonds.

MR. MCFARLAND: If the Court please, Mr. Bazley, what are you testifying from?

THE WITNESS: I have my notes.

MR. MCFARLAND: Notes that you have made? Have you made them yourself or in connection with your attorney?

THE WITNESS: No, sir, by myself.

MR. MCFARLAND: Before you spoke to your attorney about it?

[77] THE WITNESS: Absolutely.

By MR. MORRISON:

Q. Go right ahead, Mr. Bazley.

A. Furthermore, it seemed to us in conference with this management, that this plan of issuing common stock and debentures would also secure for the corporation certain benefits inasmuch as the fixed charges on the bonds would have the purpose of reducing Federal and State taxes, and it would also enlarge the percentage of dividends on the reduced value of the stock inasmuch as the value of the stock had been reduced.

Further, it would give the shareholders a security in the form of a bond which is very much less fluctuating, more readily marketable, particularly where, in the case of deceased stockholders, the bonds could be liquidated for inheritance taxes or other purposes; if it would be necessary or possible, without reducing the family management. You could still keep the Bazley management in control.

Furthermore, at the time that this reorganization was considered, the work we were doing was practically 100 per cent stripping work, mining of coal by the open pit method.

The coal business was very poor. It was almost impossible to get contracts that were profitable at that time; and we considered or were considering very seriously going into road building. Road building work is a very hazardous [78] job. Many contractors have gone into it and failed. It seemed to me that at this time, if we were going into this business, that these bonds would give to the shareholders

an obligation which, in the event of reverses in this new enterprise, would at least put them in a position to share alike with any creditor.

Q. Were there any other reasons?

A. Yes, at this same time the fixed assets of the corporation were very large in relation to the amount of stock outstanding—that is, to the face value of the stock, due to the fact that there had been an accumulation of profits that had all been turned back into the business, new equipment purchased.

We might add that the equipment used in this particular type of work is very expensive and requires a great deal of working capital. Recently, within the last two years I purchased a machine which cost approximately $200,000, and I have another one coming this fall that will cost in the neighborhood of the $200,000. As a matter of fact, this work, in order to start what I call a proper contract, sometimes demands as much as $500,000 ready cash.

I know one case required three-quarters of a million, so these fixed assets were here and had been built through accumulation, and it seemed very advisable to reflect this accumulation of earnings in the permanent dedication of these [79] funds and put it into corporation use.

Q. Now, have you any other reason, Mr. Bazley?

A. Well, those were the major reasons.

Q. Have you had any experience in banking or in connection with any banks?

A. I am vice-president of the Miners' National Bank of Pottsville, Pennsylvania, which is the largest bank in Schuylkill County.

Q. Are you a director of that organization?

A. Yes, sir.

Q. You are?

A. Yes, sir.

MR. MORRISON: Cross-examine.

CROSS-EXAMINATION.

By MR. MCFARLAND:

Q. Mr. Bazley, can you give us the names of two or three specific road building jobs that your company has performed in times past?

A. I completed the Mt. Hope job just outside of Reading, took that over from the contractor, the bonding company.

Q. When was that you are speaking of, Mr. Bazley, what year?

A. I think it was in 1940, late 1939.

Q. And when you say you completed it, what do you mean, you completed it?

[80] A. Completed it to the satisfaction of the bonding company.

Q. What did you do?

A. Built the road.

Q. Built it?

A. Completed it.

Q. You took it over from the bonding company?

A. Yes.

Q. That is near Reading, you say?

A. Five miles south of Reading.

Q. How large a contract was that?

A. I think it was something like 300,000. That is my recollection. Then we next built the 4-lane highway from St. Clair, Pennsylvania, up to Frackville.

Q. In what year was that?

A. 1940, I think. Also, South Tamaqua, 4 or 5 miles into Lehigh in that year, and recently completed 5 miles of triple and 4-lane highway. We call it the Deer Lake Highway which goes south to Orwigsburg to South Clinton.

Q. These are all in Pennsylvania?

A. Yes, sir.

Q. In what year did that latter construction take place?

A. In 1941 and 1942.

Q. 1941 and 1942? What road construction prior to 1940 [81] has your company been engaged in?

A. We had no direct contracts. We were sub-contracting, doing some of the excavating work for other contractors.

Q. Can you give me an idea as to the nature of those contracts and the locality of the work done and the years in which it was done?

A. I think New Hope, Pennsylvania, in 1938, and up in Lehigh County in the Poconos in 1939, an excavation job which we contracted. C. L. Miller was the contractor.

Q. When you say that your Company also engages in general contracting, beyond the road construction that you have just enumerated, do you do other contracting in addition to your open pit mining methods?

A. We do a great deal of miscellaneous work, heavy erection, heavy foundation, steel erection, and that sort of thing.

Q. Give me an idea of the jobs you have done in that connection from the years 1937 on up?

A. I think we moved a large steel structure from Gilberton and Colliery to some place near Tamaqua.

Q. What year was that, Mr. Bazley?

A. I cannot recall. I think it was in 1937 or 1938. We are constantly doing work of that kind. It is pretty hard for me to give a specific date.

Q. In other words, year in and year out you are doing [82] work along those lines, as well as your road construction and your open pit operations?

A. Yes, sir.

Q. Now, the open pit operations—just what does that consist of? I am not a miner, Mr. Bazley, so I don't know what it is.

A. Well, when the coal is near the surface, 7 or 8 feet below the surface to as much as 250 feet, we remove the surface and gain the coal that is underneath by stripping the top surface and mining the coal with some shovels, or

power shovels, rather, and sending the same to the colliery, or wherever the contractors made them.

Q. Ofttime, do you know how many employees in your organization you would classify as "key employees"?

A. I would say about 20.

Q. About 20?

A. 20 to 25.

Q. Out of a general total or average number of employees of about how many?

A. About 350 to 400.

Q. And has that figure been constant within the last 4 or 5 or 6 or 7 years?

A. I think it has been fairly constant.

Q. These key employees—in what capacity are they employed by the corporation?

[83] A. Engineers, superintendents and foremen and assistant foremen.

Q. Did the corporation ever sell any stock to any of them at any time?

A. Not up to the present time, no.

Q. Can you tell me just what specific advantage was gained by the corporation by the issuance of these bonds?

A. Well, I have already given you that.

Q. In general terms, but I would like to have it more specific, if you can.

A. Well, it seemed to me that it gave the corporation a better stock position, particularly to employees, inasmuch as the value of the stock would be lower and you wouldn't have to ask the employees to pay such a large price for stock as you would if you had a big accumulated surplus.

Q. How much of your earnings did you dedicate to the stock?

A. There was 300,000.

Q. You already had one you dedicated?

A. Yes.

Q. The corporation agreed to an obligation of how much by the issuance of these bonds?

A. $400,000.

MR. MCFARLAND: I believe that is all.

[84] RE-DIRECT EXAMINATION.

By MR. MORRISON:

Q. Mr. Bazley, you were asked by Mr. McFarland as to whether or not any stock had been sold to any of the key employees, and you answered that it hadn't. Were there any reasons why that stock hadn't been sold?

A. Yes, there were very good reasons.

Q. Well, first let me ask you this. Did you and Mrs. Bazley intend to sell part of your holdings to your key employees?

A. That is correct, yes.

Q. Why was that not done?

A. Well, shortly after this recapitalization was made, the business went into very much of a slump, and I personally advised the management that it was not a good time—at least, I did not feel morally that it was right to try and sell a stock which at the time, at least, did not have a good future.

Q. Do you recall, just in round figures, if you do recall at all, what earnings you had in the year following the reorganization—that is, the first fiscal year for the first full year after this recapitalization? What were your earnings? Do you recall?

A. $1,528 for the first year for the recapitalization.

Q. And what had they been, just the fiscal year ending [85] at the time of the recapitalization?

A. $104,000.

Q. Well, go on and tell us why you did not sell any stock.

A. Well, in that year, as I said, I had been in Europe that summer and expected to put this through in the fall, and when I got back I found the whole situation, in general, was very bad, and new contracts were very difficult to get, and the earnings were decidedly off, and I thought it was

not the proper thing to offer the employees stock at that time.

Q. What was the condition in Europe when you left in the summer of 1939?

A. Well, the war was on. I was there three weeks after the war started. I was in Germany when they marched into Poland, and went from there to Switzerland and managed to get home through France.

Q. Were there any other reasons why you did not feel it was proper to sell stock of J. Robert Bazley to your key employees?

A. Well, as I have already said, in the next year, in 1941, the depression in the coal business still existed, but there was decided war talk in the air. The Government was at that time making a decided effort to sell Defense Bonds. As a matter of fact, I was very much in the fore in Schuylkill County in selling them myself, and I did not feel it was a [86] proper time to take the earnings from the employees to defeat the purpose of the Government in buying Defense Bonds.

Q. Well, since that time, has any stock been sold by you or the other stockholders to the key employees?

A. No.

Q. And why not?

A. In 1941, as we all know, we had Pearl Harbor in the fall, and the bond drives were increased in tempo. As a matter of fact, I was county chairman of the Third and Fourth War Loan drives and succeeded in putting Schuylkill County in 11th place in the Fourth War Loan drive. I did not feel definitely that it was the time to offer employees stock, and I know very little of it has been done during this war effort.

Q. Do you and the other stockholders propose or contemplate selling any of this stock until after the war is over?

A. No, sir.

Q. Mr. Bazley, tell us this. You spoke of these key employees, some 20, or whatever it was. What is their average compensation from J. Robert Bazley, Inc.?

A. I would say they average around $4,000 to $4,500 a month, some as high as——

Q. Wait a minute! You say per month?

A. Per year. I beg your pardon.

Q. I was going to say, I would take a job myself. [87] Well, what is the minimum and what is the maximum?

A. The minimum is about $2,800 and the maximum is about $6,000.

Q. Do you know, of your own knowledge, whether these key employees are people of means?

A. They are not people of means. I know that definitely they would have to take their earnings to invest in the company, if anything.

Q. This is a sort of supposititious question. When and if the war is over, is it contemplated by you and the stockholders to sell them to the employees, the key employees?

A. Yes, sir.

Q. Will that depend on whether conditions are good or whether they are bad?

A. I will definitely want conditions to be favorable towards the stock before I would sell it to the employees. I feel a moral responsibility in that regard.

Q. At the time you were contemplating effecting this plan of reorganization, did you feel that by selling this stock to your key employees, that they would have a greater interest in the business of the J. Robert Bazley, Inc.?

A. I felt that they should, yes.

Q. Did you feel that they would?

A. I definitely did, yes.

Q. Mr. Bazley, you spoke of an indebtedness or some [88] contract that might go bad on you, or something like that. Did that ultimately work out satisfactorily or unsatisfactorily?

A. Yes. Is it necessary to mention names? Do you wish them?

THE COURT: That is up to you.

By Mr. Morrison:

Q. If you can, mention the names.

Mr. McFarland: What year have you reference to?

Mr. Morrison: The question you asked him about certain indebtedness going bad.

Mr. McFarland: I did not ask him about indebtedness.

Mr. Morrison: In the cross-examination he mentioned about——

Mr. McFarland: I object, if the Court please. It is not a proper re-direct examination.

Mr. Morrison: I beg your pardon. Strike that all out, please.

That is all, Mr. Bazley.

Re-Cross-Examination.

By Mr. McFarland:

Q. Mr. Bazley, I just have a few questions to ask you. Subsequent to the plan of 1939, I believe you testified that the affairs of the company, or the company did not fare too well immediately after the reorganization, as you said.

[89] A. Yes.

Q. Did your employees retain the same rate of compensation through all the period that you have reference to?

A. I am very glad to say that they did.

Q. They did. Did you ever discuss with any of the employees, other than the board of directors, the proposition of offering stock to the key employees at any time?

A. Yes, I have.

Q. When did you do this?

A. Prior to the reorganization and since. I have talked to them and saying that I would like to do it but I did not think the time was advantageous. They know that I am contemplating it, in other words.

Q. The corporation, in other words, never offered the stock to the employees at any time?

A. No.

Q. I hand you the corporate return of J. Robert Bazley, Inc., and ask you if your signature appears on that.

MR. MORRISON: May I see that, because often we have papers in here that don't belong in them.

(Mr. Morrison has several papers from the corporate return removed.)

By MR. MCFARLAND:

Q. The corporation is on a fiscal year basis?

A. Correct.

[90] Q. Fiscal April 30th?

A. That is right.

Q. Directing your attention to the corporate return filed on behalf of J. Robert Bazley, Inc., fiscal year May 1, 1939, and ending April 30, 1940, does your name appear on the face of the return?

A. Yes, sir.

Q. That is the return of the J. Robert Bazley, Inc., as filed?

A. Yes.

Q. Can you indicate from that return the net income for that year?

MR. MORRISON: Wait a minute. I object to that.

THE WITNESS: It is partly there. Part of it has been removed.

MR. MORRISON: If Your Honor please, I want the question rephrased. I want him to talk about actual net income.

By MR. MCFARLAND:

Q. Well, can you indicate to me the adjustable net income?

MR. MORRISON: You mean subject to tax?

MR. MCFARLAND: That is correct.

By Mr. McFarland:

Q. What is that figure?

[91] A. $2,257.51.

Q. Referring to the return for the fiscal year of May 1, 1940-April 30, 1941, of J. Robert Bazley, Inc., what is the adjusted, normal tax net income for that year disclosed by the return?

A. Normal tax net income, $50,676.31.

Q. Referring to the corporate return for the fiscal year May 1, 1941, to April 30, 1942. Can you tell me the normal tax net income reported for that year?

A. Normal tax net income, $58,658.95.

Q. By the way, Mr. Bazley, what was the addition disclosed on your balance sheet to surplus in that year? Your beginning surplus was what figure?

A. The earned surplus and undivided profits?

Q. That is correct.

A. $203,907.

Q. And at the end of the year?

A. $234,697.

Q. Do you recall off-hand, Mr. Bazley, what the net income of the corporation was for the fiscal year ending April 30, 1943?

Mr. Morrison: Do you mean the taxable net income?

Mr. McFarland: Taxable net income, yes.

The Witness: No, I don't.

Mr. McFarland: That is all. No further questions.

[92] Further Re-Direct Examination.

By Mr. Morrison:

Q. Mr. Bazley, you were just a moment ago stating there the taxable earnings and the surplus of the company. Did your corporation pay any dividends in the years immediately following the recapitalization? Did your corpora-

tion pay any dividends immediately following the recapitalization?

A. Yes, sir.

Q. Did it pay any dividends for years preceding the recapitalization, say five years preceding the recapitalization?

A. Yes, sir.

Q. Do you know the percentage of your earnings that were distributed as dividends? Do you know the percentage of your earnings that were distributed as dividends before the recapitalization and after?

MR. MCFARLAND: I object to this line of questioning. I think the best evidence are the books of the corporation. If Mr. Bazley will testify as to where he derives his information and the amount of payments, all right.

THE COURT: If this witness knows, the books are only evidence of what the facts are. If he knows the facts, let him do it. He is asked for his knowledge. If he doesn't know, that is something else.

By MR. MORRISON:

[93] Q. I am asking for his knowledge. Do you know?

A. They approximated it by 37 per cent.

Q. When?

A. In the years 1935, 1936, 1937 and 1938.

Q. How much did they approximate in the five years immediately following the reorganization, up to April 30, 1943?

A. About 56 per cent. or 57 per cent.

Q. In other words, you say that the corporation, in the five years preceding, distributed 38 per cent. of its earnings in the form of dividends to the stockholders. Were they cash dividends?

A. Yes, cash dividends.

Q. And that immediately after the recapitalization, that which the corporation distributed was what percentage?

A. 56 per cent. 56 or 57 per cent. It is about that.

MR. MORRISON: That is all. That is all, Mr. Bazley.

MR. MCFARLAND: Just a moment. I may have another question.

FURTHER RE-CROSS-EXAMINATION.

By MR. MCFARLAND:

Q. Mr. Bazley, directing your attention to the schedule M as appears on the income tax return of the corporation for the fiscal year May 1, 1940, April 30, 1940—1941, total distributions to stockholders in that year were $25,000, is [94] that correct?

A. That is correct.

Q. And the common stock carried on the corporation's capital stock account was $300,000?

A. Correct.

Q. What percentage is 25 in that case?

MR. MORRISON: Wait. Percentage of what?

MR. MCFARLAND: Percentage as bears relation to the 300,000.

MR. MORRISON: He wasn't asked anything about the percentage on that. He was asked about the percentage of earnings.

MR. MCFARLAND: I am asking him the question. I am not asking him what was asked.

THE WITNESS: About 8½ per cent., about 8½ per cent. A little over 8½ per cent.

By MR. MCFARLAND:

Q. For the year May 1, 1941 to April 30, 1942, did the company distribute the dividend in that year to its common stockholders?

A. That was what year? Ending when?

Q. Ending April 30, 1942.

A. Yes.

Q. How much?

A. $15,000.

[95] Q. And the capital stock and common stock was still 300,000?

A. $300,000.

MR. MCFARLAND: That is all of this witness.

MR. MORRISON: Just a minute, please.

FURTHER RE-DIRECT EXAMINATION.

By MR. MORRISON:

Q. Mr. Bazley, I show you your corporation's income and excess profits tax return for the fiscal year beginning May 1, 1938, and ending April 30, 1939, which shows on Schedule P—first of all, is that your signature on that return?

A. Yes, sir.

Q. It shows on Schedule P, total distributions to stockholders, charged earned surplus during the taxable year in what amount?

A. $70,000.

Q. Do you recall whether that distribution was made immedately after or prior to the recapitalization?

A. It was made immediately after.

MR. MORRISON: That is all.

MR. MCFARLAND: On what date, if you recall?

THE WITNESS: Well, it was made during that fiscal year.

MR. MORRISON: Yes, but you say immediately after.

[96] Now, what month was it?

THE WITNESS: Well, it was up to——

MR. MORRISON: No, what month did you make the distribution?

THE WITNESS: I am not sure exactly what date.

MR. MORRISON: But what month? You say it was after the recapitalization. What month was it?

THE WITNESS: I think it was March or April.

MR. MORRISON: After recapitalization?

THE WITNESS: Yes.

MR. MCFARLAND: What event associates itself in your mind to say it was either March or April?

THE WITNESS: Because that was usually the time we consider dividends.

MR. MCFARLAND: In other words, you have no specific knowledge other than what you normally do?

THE WITNESS: That is right. I am quite confident that is why.

MR. MCFARLAND: Do you know.

THE WITNESS: No, I don't know definitely.

MR. MCFARLAND: Very well. That is all.

MR. MORRISON: That is all.

THE COURT: Mr. Bazley, just a moment, please.

THE WITNESS: Yes.

THE COURT: Do you happen to have—I notice that [97] you referred to the earnings of the year, as I recall it, just before the recapitalization. Was that around $100,000, did you say?

THE WITNESS: Before the recapitalization.

THE COURT: A year before it?

THE WITNESS: The year before it was $65,000.

THE COURT: And didn't you mention the figure of $104,000?

THE WITNESS: As the year of the capitalization, yes. In other words, that year ended about two months after the recapitalization, three months after the recapitalization.

THE COURT: And that was the most profitable year, or one of the most profitable years that you had, is that right?

THE WITNESS: Up to that time, yes.

THE COURT: So that there were what, two or three months between the recapitalization and the end of that year?

THE WITNESS: Yes.

THE COURT: Did you make it clear why it was you did not take up advantage of that two or three months period to dispose of this stock as you say you planned to?

THE WITNESS: Well, I did not definitely know what the earnings would be until after the end of the year, and then, as I say, my contracts were expiring with the various coal companies, and the outlook at that time was very poor.

[98] THE COURT: Well, didn't you know before recapitalization that those contracts were going to expire?

THE WITNESS: Yes, but I did not know definitely that the output was going to be as bad because March and April are always the worst months in the coal business. At that time this bootleg business was extremely bad in Pennsylvania and we had the worst outlook for coal for some time, particularly for stripping work.

THE COURT: For how long?

THE WITNESS: Well, I would say ten years.

THE COURT: Had the business been fairly stable during the ten years before that, or, by business, I mean, had the profits been roughly about the same?

THE WITNESS: No, they were up and down, I would say.

THE COURT: The coal business is up and down?

THE WITNESS: That is correct.

THE COURT: You knew that before you ever planned this distribution, didn't you?

THE WITNESS: That is right.

THE COURT: Would one bad year put you in a frame of mind where you thought you shouldn't carry on this plant?

THE WITNESS: Frankly, I had no confidence in the future of the coal business along about late 1939 and 1940. Very lately, the war has brought it back.

THE COURT: Do you want to say something?

[99] MR. MORRISON: Yes, I do, Your Honor, because if you are going to question him along those lines, I want to ask him what the earnings were after the recapitalization.

THE COURT: I think it has already been given, but I will be glad to have you put those in.

MR. MORRISON: I don't recall that you had.

THE COURT: One year, as I recall it, they were 54,000.

MR. MORRISON: That was taxable income.

THE COURT: Well——

MR. MORRISON: It could be $9,000 or $10,000 less than that.

THE COURT: Well, if you are going to draw distinction of importance between taxable income and distributable income, why, I would be glad to have those figures go in, because otherwise it leaves the record in a very unsatisfactory position.

MR. MORRISON: Off the record.

THE COURT: I would rather not have it off the record.

MR. MORRISON: The earnings after April 30, 1939, were not as good as they were before.

THE COURT: How do you mean, not as good? Do you know they compare?

MR. MORRISON: Yes, I do.

[100] THE COURT: How?

MR. MORRISON: For the five years, for the five full fiscal years prior to recapitalization, that is, up to April 30, 1938, from the figures that I have jotted down here from the accountant's certified report, they had $394,000 of earnings.

THE COURT: That is for the five years, total?

MR. MORRISON: That is for the five years preceding, yes. There was one year of loss back in 1935.

Now, in 1939, right after the period of recapitalization, recapitalization became complete in March, and this is for the year ending April 30, 1939, the end of the next month. It was $104,000.

THE COURT: That is for one year.

MR. MORRISON: Yes. That is just in the short period, that is, for that full twelve months, but the results were not known until April 30, 1939.

Now, the next fiscal year it only amounted to $1500.

THE COURT: That was the one Mr. Bazley testified made him change his mind.

MR. MORRISON: In the year following that, 45,000, and in the year following that, which is April 30, 1943—and we were very much in the war then and a great demand for coal existed—it was 140,000.

[101] THE COURT: How does that first five years average, for which you gave me a total?

MR. MORRISON: It was—it would average approximately $80,000 a year.

THE COURT: You deduct $24,000 from that and what do you get?

MR. MORRISON: Well, that is previously deducted. Well, I see what you mean. You mean on the bond.

THE COURT: Yes.

MR. MORRISON: But you are still better off.

THE COURT: What do you get?

MR. MORRISON: You get 370—oh, $24,000 a year. 120? You get $274,000.

THE COURT: Well, I asked you for an average. I think perhaps it wasn't a little bit high. You said five years.

MR. MORRISON: Five years. $394,000.

THE COURT: 394? I thought you said 314.

MR. MORRISON: 394, and you get an average of about 80.

THE COURT: And if you deduct 24,000 from the 80,000, that will give you the average to compare with the subsequent point.

MR. MORRISON: That is correct.

THE COURT: What will that be, about? What would [102] 24 from 80 come to?

MR. MORRISON: 56,000.

THE COURT: 56,000 is just about the average of the post-reorganization years, isn't it, if you leave out that one $15000 year?

MR. MORRISON: No, it isn't, because you have ascribed immediately after the reorganization that full 12-month period. That technically belongs in the prior period. In other words, as of March, 1939, in that year—ten months or eleven months of that year had gone by before the bonds were issued, and that was one of the best years that they had.

THE COURT: Leaving out the $1500 year——

MR. MORRISON: Call it zero?

THE COURT: Because I understand that that is a pivotal year in this discussion.

Mr. Morrison: That is right.

The Court: I understood Mr. Bazley to say that that was such a bad year that it was the reason he did not go ahead with his plans.

Leaving that year out, how did the earnings run?

Mr. Morrison: Well you have got to put your average in. To get your proper average you have to put it in there, or let us make it zero.

The Court: If you put that in and put the $140,000 year, what is your average?

[103] Mr. Morrison: That doesn't make the proper average. For a period of time you are working on a different proposition. Ten months of the year's earnings were earned.

The Court: You misunderstand me. I am talking about 1943. What were the earnings of 1943?

Mr. Morrison: $140,000

The Court: If you put that in and put the zero year in, what average do you get?

Mr. Morrison: Approximately 60,000.

The Court: That is not very different from the 56,000 of the previous years.

Mr. Morrison: No.

The Court: In fact, it is better, if anything, because you are putting in the year 1939 without ten months.

Mr. Morrison: That already expired before the reorganization.

The Court: I did not ask you to put in 1939.

Mr. Morrison: Well, then, if you did not, let us take it out.

The Court: I asked you for the figures.

MR. MORRISON: Well, then I will give it to you right now. The average there will be $57,000.

THE COURT: Just about the same as the pre-reorganization year; is that right?

MR. MORRISON: That is right.

[104] THE COURT: So you cannot say that there was very much change in the business from an over-all standpoint for the whole ten years.

MR. MORRISON: After 1939 you come through 1940, 1941 and 1942 and 1943 and you start to make money.

THE COURT: Isn't that the history of the coal business? If you go back, $104,000 was the profit in 1939, which was not a war year, was it?

MR. MORRISON: Yes, but let me mention 1934, 1935, 1936, 1937 and 1938, and you will get the picture. In 1934, $125,000; 1935, a loss, $4,800, although they paid tax on taxable income, for some reason. The actual result was a loss of $4,800.

THE COURT: Let me interrupt you, Mr. Morrison. It occurs to me that if our discussion here is germane—and, if it isn't, I am just as much at fault as you are. If it is, these figures will not be in the record, because I cannot take the statement of counsel as facts. In other words, I am just pointing out to you so if you think it is material to your case to have them in—maybe you can arrange to have them stipulated with Mr. McFarland.

MR. MORRISON: I can get them in five minutes with another witness.

THE COURT: If we are not talking about materiality, [105] we should get them in.

MR. MORRISON: That is all.

FURTHER RE-CROSS-EXAMINATION.

By MR. MCFARLAND:

Q. One more question, Mr. Bazley. Referring to this compensation of the employees immediately after and at approximately the same time that this February 1, 1939, plan of reorganization was entered into, you referred to the fact that the employees were able to maintain their level of compensation through the lean and flush period, is that right?

A. That is correct.

Q. Did it occur to you that you would probably get an added incentive to the employees if you did offer them stock on a reduced basis on what you determined to be the value of that stock so they could realize it in later years?

A. I had expected to do that.

Q. You did not do it right up to the present?

A. As I previously stated, I did not feel the time was opportune.

Q. And you haven't done it up to the present time?

A. No.

MR. MCFARLAND: That is all.

FURTHER RE-DIRECT EXAMINATION.

By MR. MORRISON:

Q. Mr. Bazley, just a minute. Do you know, of your own [106] knowledge, whether your employees were buying War Bonds and Defense Bonds in that period that the Government was issuing them?

A. My employees are buying their quota of Defense Bonds, I am very glad to say.

Q. Have you personally urged that to be done?

A. Yes.

Q. Including the key employees?

A. Absolutely.

MR. MORRISON: That is all.

THE COURT: Take a ten-minute recess.

(Whereupon, a ten-minute recess was taken.)

MR. MORRISON: If Your Honor please, with regard to the earnings and dividends, there are two ways we can obviously do it. One is to stipulate them. The other is to call a witness. I will do whatever you wish in the matter. It might save a little of your time, that is all.

THE COURT: I would prefer a stipulation, if that is possible. Then I would be sure that there isn't any possible dispute about it.

MR. MORRISON: Thank you. It will only take about a minute or two.

THE COURT: Now, Mr. Morrison, let me ask you this.

You have other witnesses, have you?

MR. MORRISON: I have the certified accountant who [107] keeps the books of the corporation regularly, and he makes up their tax returns and just looks after and does all their bookkeeping, and I was going to call him.

THE COURT: You are going to call him in any way.

MR. MORRISON: No, for two purposes. One, to give the earnings and dividends in the five years before the reorganization, five years after, and the dividend record, and the additions to plant, or fixed assets. That is my case there.

THE COURT: And that is all the testimony you were going to put in?

MR. MORRISON: Yes.

THE COURT: So the question is whether you should call him, or stipulate.

MR. MORRISON: Get these gentlemen to agree to stipulate it. They can't from their figures stipulate the additions to plant. We can show clearly what the

additions to plant were. The Government can do it from their returns, but it will take quite some time, whereas this accountant knows of his own knowledge. He supervised the work done by his men.

THE COURT: I am trying to save as much time as possible. I was thinking of this possibility: That you put the accountant on for whatever it is you think we have to do anyway. Then we can take a recess until after lunch, and I [108] will give you time to work out a written stipulation, and we can reconvene and have you put that in.

MR. MORRISON: I had hoped to finish everything by a quarter of twelve.

THE COURT: I know you had, but I was wondering how long we would have to delay here for this stipulation.

MR. MORRISON: Are you ready?

MR. MCFARLAND: Yes.

(Discussion off the record.)

MR. MORRISON: If the Court please, counsel for the respective parties will stipulate the earnings and the dividends for the five fiscal years preceding the date, the plan of recapitalization— I beg your pardon. He doesn't agree to that.

The date, the agreement, the steps under the agreement were finally consummated. I will first give a list of the earnings, and they are as follows:

For the fiscal year ending April 30, 1934, $117,908—is it agreeable to you to leave off the pennies?

MR. MCFARLAND: Yes.

MR. MORRISON: $117,908; 1935—you might say fiscal year 1935—loss, $4,828; 1936, $106,891; 1937, $96,894; 1938, $65,717.

Now, all of those years or those amounts reflect profits of those years except the year 1935 when a loss, as [109] stated above, was incurred.

The dividends in that period were as follows:

1934, none; 1935, none; 1936, $10,000; 1937, $75,000; 1938, $65,000.

Now, the earnings and dividends for the fiscal years thereafter—that is, from April 30, 1939 to April 30, 1943, were as follows: 1939, $104,178; 1940, $1,528; 1941, $45,015; 1942, $43,884; 1943, $140,549.

The dividend record in that period was as follows—these are all cash dividends. All the dividends I mention are cash dividends:

In 1939, $70,000; 1940, $10,000; 1941, $25,000; 1942, $15,000; 1943, $70,000.

Do you want 1944? That is five full fiscal years before, and those after.

Now, the earnings and dividends for the fiscal year ending April 30, 1944, which just closed. The earnings were $102,890, and the dividend was $70,000.

Mr. Lefferts, will you take the stand?

Whereupon, WILLIAM REUBIN LEFFERTS, called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

[110] DIRECT EXAMINATION.

By MR. MORRISON:

Q. Mr. Lefferts, please state your full name and address.

A. William Reubin Lefferts. Do you want the address?

Q. Yes.

A. Business address?

Q. Business address.

A. Lincoln Liberty Building, Philadelphia.

Q. What is your business, Mr. Lefferts?

A. Certified public accountant.

Q. Of what State?

A. Pennsylvania.

Q. Are you the certified accountant—are you employed by the J. Robert Bazley, Inc.?

A. I am.

Q. How long have you been employed with them?

A. Since about April, 1930.

Q. Do you keep the books and records of that corporation, or are they kept by men in your office under your supervision?

A. We take the books of original entry and carry forward the bookkeeping work from that point into the general ledger.

Q. Are you familiar with the books of original entry, as well as the books that you keep?

A. I am.

[111] Q. Will you tell us when in the fiscal year 1940—in the fiscal year ending April 30, 1939, the corporation paid a dividend of $70,000?

Mr. McFarland: The books from which the witness testifies are what?

Mr. Morrison: Is the general ledger.

What did I state before?

(The reporter read the last question.)

Mr. McFarland: I have no objection to the witness stating what the book shows, but what he thinks it shows on something that doesn't appear thereon, I object to.

The Court: Let me ask you, Mr. Morrison, isn't this within the field of that stipulation?

Mr. Morrison: No, Your Honor. You recall that Mr. Bazley was asked about whether a dividend was paid immediately after the reorganization, and he was somewhat hazy about it? He knew there was $70,000, and he wasn't sure whether it was one month after or

two months after, and the exact date, and this is to show you clearly when the dividend was paid.

THE COURT: What you are asking this witness is, is to testify what the books show.

MR. MORRISON: What the book shows as being the date on which the dividend was paid.

THE COURT: That is all you want, isn't it, Mr. McFarland?

[112] MR. MCFARLAND: Well, the book merely gives an entry on April 28, 1939. What is the V?

THE WITNESS: V for voucher record.

MR. MCFARLAND: 153, dividends paid in the amount of $70,000, or is that a 4?

THE WITNESS: No, a 7, $70,000.

MR. MCFARLAND: $70,000.

THE COURT: I don't get the basis of your objection.

MR. MCFARLAND: He is testifying. I have no objection to the answer as the witness has just stated it.

THE COURT: Very well.

By MR. MORRISON:

Q. Do you know, Mr. Lefferts, from your knowledge of the company's affairs, as to whether it was paid on that date or not?

A. To make sure, I have the voucher record with me.

Q. Will you get me that, please?

A. I will corroborate this entry.

Q. Will you get it, please?

A. I will.

(The witness gets the voucher record.)

MR. MCFARLAND: Will you identify that book for the purpose of the record?

MR. MORRISON: I will.

By Mr. Morrison:

[113] Q. Mr. Lefferts, what is this book I am trying to lift up here?

A. It is entitled "Voucher Record."

Q. And is that the voucher record of the J. Robert Bazley, Inc.?

A. It is.

Q. What does that show as having been paid in the way of dividends—as of what date, April 27?

Mr. McFarland: May I just ask a question.

Do these entries appear in your handwriting?

The Witness: No.

By Mr. Morrison:

Q. They are in the handwriting of whom?

A. Of the clerk of J. Robert Bazley.

Q. Do you know who that clerk might be?

A. I am pretty sure it was a certain gentleman by the name of Chester Williams. It is either Chester William or Richard Evans.

Q. When you make your examination of the accounts of this corporation, do you examine this book? This voucher record?

A. We do.

Q. And do you know that to have been written prior to the time that you made your examination for the fiscal year [114] ending April 30, 1939?

A. I do.

Q. What date is shown here as the date of the payment of the dividend aggregating $70,000?

A. April 28, 1939.

Mr. McFarland: Mr. Lefferts, these entries made on this book are the closing entries of the month of April, 1939; is that not correct?

The Witness: No.

By Mr. Morrison:

Q. What are they?

A. These are the original entries.

Q. Are these the daily entries?

A. That is right.

Mr. McFarland: From where were these entries taken?

Mr. Morrison: From the check book.

The Witness: No. The bulk of the entries from this book arise from invoices for purchases, but it was also the custom of the corporation to enter a voucher and give it a number where any payment was contemplated. They would first record it in this book and then record the date of payment alongside of it.

Cross-Examination:

By Mr. McFarland:

Q. Directing your attention to the entries to which you have reference, from what book or from what voucher or [115] from what source were these entries made—taken?

Mr. Morrison: Give the voucher number.

The Witness: Voucher numbers 4180, 4181 and 4182.

By Mr. McFarland:

Q. Voucher No. 4180 being what voucher?

A. That is the number on the voucher given to a proposed payment to J. Robert Bazley, described hereon as being a dividend of $3,990 shares of J. R. B., Inc.

Q. The next voucher?

A. The next voucher, 4181, describes a proposed payment to Alice H. Bazley for a dividend of 1,005 shares of JRB, Inc.

Q. And the next voucher?

A. I should add that the amount of voucher 4181 is $1,470, and the amount of voucher 4180 is $55,860. The

third voucher is 4182, showing the proposed payment to Alfred Day of a dividend of five shares of JRB, Inc., $70.

Q. Can you tell from this entry, when the dividends were actually paid?

A. I can.

Q. You say, a proposed dividend?

MR. MORRISON: He said proposed payments, not a proposed dividend.

MR. MCFARLAND: All right, that is what I said.

THE WITNESS: Proposed payments. The next step in this book is to record thereon the date [116] of payments of the vouchers.

MR. MORRISON: What dates, roughly?

THE WITNESS: It is recorded that these three vouchers are paid on April 28, 1939.

MR. MORRISON: That is all?

MR. MCFARLAND: That is all as far as I am concerned.

RE-DIRECT EXAMINATION.

By MR. MORRISON:

Q. Just a moment. Can you tell us, from your own knowledge, what additions to fixed assets, such as plant, buildings, equipment, were made by J. Robert Bazley, Inc., from the time of the reorganization down to the present time or to the end of the fiscal year, April 30, 1944?

MR. MCFARLAND: Where does he get his information?

By MR. MORRISON:

Q. Where do you get your information? Have you any information pertaining to the additions to the plant of J. Robert Bazley, Inc.?

A. I do.

Q. Where do you get that information?

A. From the reports which we prepare as a result of an annual examination.

Q. Examinations of what?

A. Of the affairs of J. Robert Bazley, Inc.

Q. Contained in what? What are the affairs contained [117] in? How do you know what these affairs are?

A. From the books of the corporation.

Q. Now, do you have before you a list of these additions of plant from the time of the recapitalization down to April 30, 1944?

A. I do.

Q. Please state them.

MR. MCFARLAND: Well, I object, if the Court please. I have nothing to cross-examine him on other than the accuracy of what he has taken from the books. The books are the best evidence. I cannot cross-examine him on a thing here.

MR. MORRISON: Yes, he can, Your Honor. He cross-examined Mr. Bazley on the corporation's income tax returns a moment ago.

MR. MCFARLAND: Well, I will cross-examine him.

THE COURT: I understand when you asked this witness whether he knew these things of his own knowledge, you are withdrawing that question now and asking him whether he has any information about it.

MR. MORRISON: No, I am asking him if he knows of his own knowledge whether any additions were made to plant, and he does know that.

THE COURT: You have already asked him that, and he says he knows by hearsay. First of all, it was in the books, and then taken off the books and put in their annual audit [118] accounts, and then put on these pieces of yellow paper from which this witness is going to testify, is that right?

MR. MORRISON: Wait, if Your Honor please. I think you have overlooked something, and that is, that this is the gentleman who has knowledge of the books and records of this corporation.

THE COURT: If possible, he can go back to the books and get these figures.

MR. MORRISON: He could go back to the books and records, and that is what he has done there.

THE COURT: Has he got the books and records here?

MR. MORRISON: Have you got the books and records here?

THE WITNESS: Yes.

MR. MORRISON: Will you get them?

THE WITNESS: What about the time consumed here?

MR. MORRISON: That is not relevant. That is not your concern.

MR. MCFARLAND: Your Honor, I don't see how this has any relevancy.

THE COURT: Just a minute. You made an objection which, technically, although I haven't said so, it may be I will have to sustain as being proper from a technical standpoint, and I suppose that if I did not sustain your objection, you would be technically entitled on cross-examination to go and [119] get the books and show how he got the figures, and this is just a short cut to it anyway, but if you really don't see why this is material and if you do not think it is material, then I will ask you the question whether you find it necessary to make this technical objection.

In other words, if this witness is satisfied that these are the correct figures, and you are satisfied it doesn't make any difference anyway, I am just won-

dering if we should take the time of everybody here to get this.

Mr. McFarland: I don't want to unduly encumber the record, but maybe if we had a short recess to check the figures and see what Mr. Morrison proposes the book show, we can stipulate this or agree to cut some of the red tape.

My object is very sincere on the technical grounds, and also, what I just don't see the purpose or the relevancy of the testimony.

The Court: I can see the possibility that this testimony is material, and if it is, I am not going to prevent Mr. Morrison from putting this in, but I do want to renew a suggestion I made earlier, and that is the possibility we can recess now until two o'clock and you can use that time to go over the testimony that Mr. Lefferts will have to give anyway, with Mr. McFarland, and the member of the technical staff, and then I should suppose that they could be satisfied if these figures were accurate.

[120] Will you say, Mr. McFarland, if you can satisfy yourself from this preliminary examination of the books that these figures are accurate, you won't object to the form in which they are introduced?

Mr. McFarland: I won't object to the form in which they are introduced.

The Court: So even if you cannot stipulate it, you can save time.

Mr. Morrison: It is all right. I had hoped to save time.

The Court: I think you are just doing the opposite.

Mr. Morrison: I agree. If it is agreeable to you, that is the way we will do it.

THE COURT: I have another case coming on at two o'clock, and I am assuming what will be left will be a matter of only a few minutes. If not, I would prefer we go ahead with everything we have in this case and leave just this one question to be settled.

MR. MORRISON: Except this, Your Honor. I am going to ask, as you suggested when we were discussing our opening remarks, that in view of the evidence submitted here, in all fairness to the petitioners, the taxpayers in this case, I think they should be apprised of what is the Commissioner's position after hearing this evidence.

THE COURT: I have suggested to you at the time that [121] before I will ask the respondent to do that, I have got to be shown that you have some further evidence. If it makes a difference to you whether you produce it or not, depending on what the respondent says, because you have told a whole story here and it is just a question of the legal interpretation of these facts, I can get it from your briefs a whole lot better than I can get it by having the respondent give me legal argument here and now, but, if as I say, it makes a difference in the quantum of evidence that you put in, and you can show me what that is, I will consider the question further.

MR. MORRISON: Very well. I am going to call one witness, the secretary of the company, to identify the amount and figures of the dividend.

THE COURT: You have no objection if that witness goes on now or later?

MR. MORRISON: Do you want me to call him now or later?

THE COURT: Now, if you please.

MR. MORRISON: Mr. Day, will you take the stand?

Whereupon, ALFRED DAY, called as a witness for and on behalf of the Petitioner, having been first duly sworn, was examined and testified as follows:

[122] DIRECT EXAMINATION.

By MR. MORRISON:

Q. Mr. Day, I hand you a book——

THE COURT: Just a minute. Have we got this witness' name?

MR. MORRISON: I am sorry.

By MR. MORRISON:

Q. What is your name?

A. Alfred Day.

Q. What is your business?

A. Secretary-manager of J. Robert Bazley, Inc.

Q. Were you secretary of J. Robert Bazley, Inc. in 1939?

A. I was.

Q. What is this book I am showing you?

A. This is a report——

Q. What book is it?

A. That is a minute book.

Q. Of what?

A. Of the directors of J. Robert Bazley and the shareholders of J. Robert Bazley, Inc.

Q. Do you recall this meeting of April 25, 1939, held at the office of the company at Port Carbon, Pennsylvania?

A. I do.

Q. Is that your name signed there to the waiver of the [123] notice of the meeting?

A. It is.

Q. Now, was a dividend declared at that meeting?

MR. MCFARLAND: Well, what transpired at that meeting in relation to this contemplated dividend——

By MR. MORRISON:

Q. Was there a resolution adopted at that meeting regarding a dividend?

A. Yes.

Q. Read the resolution, please.

A. "Resolved, To immediately pay a dividend on common stock of $14 per share, or a total of $70,000, same to be paid in cash to stockholders of common record on April 25, 1939."

Q. So, was that motion duly made, seconded and adopted?

A. It was.

Q. That is all—oh, do you know of your own knowledge when that was paid?

A. No, I don't remember.

Q. Would it be a week later or a few days?

MR. MCFARLAND: If the Court please, he just said he doesn't know.

By MR. MORRISON:

Q. Do you know whether it was paid within a week?

A. The date?

[124] MR. MCFARLAND: I object.

MR. MORRISON: Your Honor, I asked him if he knew the date. Now I am asking if it was paid within a week after the declaration of this dividend.

THE COURT: I am just wondering, Mr. Morrison, what you are going to gain by this. You have already got the testimony of when the books were made up. Can you get anything but a different answer from this witness?

MR. MORRISON: That is perfectly all right.

(The witness rises.)

THE COURT: Just a minute, Mr. Day. Any cross-examination?

MR. MCFARLAND: No cross-examination.

THE COURT: Thanks.

(Witness excused.)

MR. MORRISON: May I call Mr. Lefferts, or do you suggest we take a recess until two o'clock?

THE COURT: In other words, that is your case except the line of testimony respecting the additions to plant?

MR. MORRISON: That is right.

THE COURT: Now, Mr. McFarland, I understand you are through with any cross-examination of Mr. Lefferts except on something that might bear on that open question.

MR. MCFARLAND: That is right.

THE COURT: Will you have any witnesses?

[125] MR. MCFARLAND: I don't contemplate having any testimony.

THE COURT: You know what Mr. Lefferts will testify to aside from what has already gone in?

MR. MCFARLAND: Yes.

THE COURT: I am going to ask you to put your witnesses on now, if you have any.

MR. MCFARLAND: No, we will not have any witnesses at any time.

THE COURT: Or any documentary evidence?

MR. MCFARLAND: I will ask that the returns on the individuals for the tax years be introduced as Respondent's Exhibits.

THE COURT: Have you any objection to doing that now?

MR. MCFARLAND: No.

THE COURT: What I am getting at is, I don't want to hold these other people up when they come here at two o'clock to try their case. You have no objection to the order of this?

MR. MORRISON: Not a bit.

THE COURT: That is all.

MR. MCFARLAND: You have no objection to that?

MR. MORRISON: No, I have not.

MR. MCFARLAND: Respondent offers the individual [126] income tax return of J. Robert Bazley for the year 1939 as Respondent's Exhibit A.

THE COURT: There is no objection, is there?

MR. MCFARLAND: No objection.

THE COURT: Be received and marked in evidence.

(The document referred to was marked and received in evidence as Respondent's Exhibit A.)

MR. MCFARLAND: Offer as individual income tax return of Alice H. Bazley for the year 1939 as Respondent's Exhibit B.

MR. MORRISON: No objection.

THE COURT: Received and marked in evidence.

(The document referred to was marked and received in evidence as Respondent's Exhibit B.)

MR. MCFARLAND: May leave be given to withdraw the Respondent's original photostats?

THE COURT: No objection.

MR. MORRISON: No objection.

THE COURT: It may be done.

MR. MCFARLAND: That is the Respondent's case.

THE COURT: That will be the the Respondent's case.

Now, we understand that for both parties the proceeding is being left open for the purpose of dealing with this question of additions to plant, and no other purpose, and of course, we will set the time of briefs at that time.

[127] MR. MCFARLAND: Right.

THE COURT: Take a recess until two o'clock.

(Whereupon, at 12:05 P. M., a recess was taken until 2:00 P. M. of the same day.)

[128] AFTERNOON SESSION.

MR. MORRISON: If Your Honor please, instead of asking any further questions of Mr. Lefferts, the parties have agreed to stipulate this matter, and I quote:

"It is hereby stipulated and agreed by the parties hereto that the net additions to plant and equipment increased from $719,782.41 at April 30, 1939 to $1,051,933.03 at April 30, 1944."

The petitioner rests.

MR. MCFARLAND: Respondent rests.

THE COURT: Very well. What about briefs?

MR. MCFARLAND: Shall we submit them under the rules, if the Court please?

MR. MORRISON: Under the rules, 30 days.

THE COURT: Satisfactory. Very well, 45 days for the principal briefs and 15 days for each side to reply.

THE CLERK: October 27th for the original briefs and November 11th for the reply.

(Whereupon, at 2:10 P. M., the hearing in the above-entitled matter was closed.)

MEMORANDUM FINDINGS OF FACT AND OPINION.

4 T. C. No. 108.

THE TAX COURT OF THE UNITED STATES.

Alice H. Bazley,
Petitioner,
v.
Commissioner of Internal Revenue,
Respondent.

J. Robert Bazley,
Petitioner,
v.
Commissioner of Internal Revenue,
Respondent.

Docket Nos. 1520 and 1521. Promulgated February 28, 1945.

Distribution to petitioners of debenture bonds along with new common stock upon the surrender and redemption of old common stock of corporation, of which petitioners were virtually sole stockholders, *held*, not a reorganization resulting in a tax-free exchange under section 112, since lacking a true business purpose, but essentially equivalent to a taxable dividend under section 115 (g). *Gregory v. Helvering*, 296 U. S. 465, followed.

Frederick E. S. Morrison, Esq., and *Calvin H. Rankin, Esq.*, for the petitioners.
W. J. McFarland, Esq., for the respondent.

By these consolidated proceedings petitioners challenge respondent's determination of deficiencies in their income tax for the year 1939 as follows:

J. Robert Bazley	$214,170.52
Alice H. Bazley, his wife	35,734.40

J. Robert Bazley will sometimes hereinafter be referred to for convenience as petitioner.

The primary question involved is whether the petitioners are taxable as charged by respondent with having received ordinary income during the taxable year to the extent of the face value of bonds of J. Robert Bazley, Inc., received in that year. A subsidiary question is whether the transaction, pursuant to which the bonds were transferred to petitioner, constituted a tax-free reorganization.

The record was made on a stipulation of facts and evidence adduced at the hearing. Those facts hereinafter appearing which are not from the stipulation are otherwise found from the record.

FINDINGS OF FACT.

The stipulated facts are hereby found accordingly.

Each of the petitioners for the calendar year 1939 filed a separate income tax return with the collector of internal revenue for the first district of Pennsylvania on or before March 15, 1940. Their books and their income tax returns were on a cash basis except for a hauling business which petitioner conducted as a sole proprietor and which is on an accrual basis. J. Robert Bazley, Inc., is on an April 30th fiscal year basis of accounting and files its Federal tax returns on that basis. Petitioners reside in Pottsville, Pennsylvania.

J. Robert Bazley, Inc., was incorporated under the laws of the Commonwealth of Pennsylvania on May 1, 1930, with an authorized capital of 1,000 shares of a par value of $100 per share. On February 1, 1939, this stock was owned as follows:

Petitioner	798 shares
Alice H. Bazley	201 shares
Alfred Day	1 share

All of the foregoing constituted the board of directors of the corporation.

Petitioner was the president and treasurer. He is a contracting engineer with a degree of mechanical engineering from the University of Michigan and 33 years' experience as a mining and consulting engineer. The corporation engaged in general heavy contracting business, including road building, the moving of industrial facilities, installation of heavy foundations and steel work, and removing the overburden from coal to facilitate its mining by the open-pit method. Shortly prior to the year 1939 the corporation was almost entirely engaged in its mining operations. At this time it first considered going into the road building work which is hazardous and requires considerable working capital. Many road building contractors have failed.

The yearly average of the corporation's employees during the years 1937 to 1940 approximated 400, of which approximately 25 were classified as key employees, including superintendents, engineers, and foremen. The latter's average yearly compensation was $4,500. The corporation maintained throughout the period 1938 to 1941, inclusive, a consistent rate of compensation for its employees.

Reasons for adopting the transaction hereinafter described involving the issuance of additional common stock and of debenture bonds were that the original shareholders, by obtaining debenture bonds for their stockholdings, would receive a security which was much less fluctuating and more readily marketable, particularly in case it was necessary for a deceased shareholder's estate to liquidate his investment in the corporation in order to meet inheritance taxes or for other purposes, and that if it became necessary to sell some portion of their investment in the corporation the debenture bonds could be sold without reducing the Bazley family stock control of the corporation; that the contemplated entry into the hazardous road building business made it desirable to put the original stockholders in possession of

bonds which would place them in a position of sharing alike with creditors to the extent of the debentures instead of ranking after creditors if the business did not succeed; that as of February, 1939, the corporation had plant and equipment of a value ($719,782.41 as of April 30, 1939), which was large in relation to the $100,000 par value of the capital stock outstanding, and since the equipment had been purchased by the use of funds acquired through the accumulation of $855,783.07 of earnings and profits since the organization of the business in 1930, it was thought advisable to reflect a more permanent dedication to corporate use of these earnings by reducing the surplus available for dividends and transferring a portion thereof to the capital stock account and another portion to the long-term debt represented by 20-year debenture bonds.

On February 6, 1939, a special meeting of the corporation's board of directors was held at which petitioner announced that the meeting was called to discuss the advisability of reorganizing and recapitalizing the corporation. He read to the board the proposed plan of reorganization and advocated its adoption, stating that the plan had been discussed with counsel for the company and with the company's accountants and that the consensus of their opinion was that the plan was advantageous to the corporation and its stockholders. A motion was duly presented and unanimously carried that the plan be adopted. Authority was also granted to make the necessary increase in the capital stock of the company.

The plan of reorganization recited that the capitalization as of February 1, 1939, was 1,000 shares of $100 par value common stock, or $100,000 and earned surplus of $855,783.82. The plan provided for issuance of 5,000 shares of common stock of no par value (with a stated value of $300,000) earned surplus of $255,783.82 and $400,000 principal amount of 6 percent debenture bonds. The corporation was to issue in exchange for the old stock, the new stock and the debenture bonds after which the old stock

was to be cancelled. Bonds were to be dated February 1, 1939, and payable February 1, 1959. They were callable in whole or in part and bore interest at the rate of 6 percent per annum. On February 16, 1939, the owners of the outstanding capital stock of the corporation held a special meeting pursuant to resolutions adopted by the board of directors at the February 6, 1939, meeting and took formal action, approving the proposed plan of reorganization and passed resolutions authorizing the necessary corporate action for its consummation.

On March 6, 1939, the Commonwealth of Pennsylvania approved the amendments to the company's Articles of Incorporation increasing the authorized common stock.

In accordance with the resolution adopted at the meeting of the shareholders of J. Robert Bazley, Inc., held on February 16, 1939, the capital structure of the company, which prior to the consummation of the terms of said agreement, was as follows—

1,000 shares common stock of par value of $100 per share	$100,000.00
Earned Surplus	855,783.82
Total	$955,783.82

was changed as shown by the corporation's books of account, as follows:

5,000 shares common stock without nominal or par value, the stated capital applicable to which is	$300,000.00
Earned Surplus	255,783.82
Outstanding Debenture Bonds	400,000.00
Total	$955,783.82

Pursuant to the plan, the stockholders on March 16, 1939, delivered their 1,000 shares of common stock to the corporation and received from the corporation the 5,000 shares of its new common stock and debenture bonds in

the aggregate principal amount of $400,000. The old common stock was cancelled by the corporation.

The following schedule reflects the distribution of the common shares and the 20-year 6 percent debenture bonds of the corporation prior and subsequent to the consummation of the plan:

		Received Under Agreement of 2/1/39	
Name	Old Stock Held Shares	New Stock Shares	Debentures Principal Amount
J. Robert Bazley	798	3,990	$319,200.00
Alice H. Bazley	201	1,005	80,400.00
Alfred Day	1	5	400.00
Total	1,000	5,000	$400,000.00

The 5,000 shares of the new common stock and the $400,000 face amount 20-year debenture bonds so issued had a fair market value on March 16, 1939, of not less than $300,000 for the common stock and $400,000 for the bonds.

J. Robert Bazley, Inc., and petitioners have never sold or offered to sell any of its stock to its key employees. After the recapitalization petitioner went to Europe in the summer of 1939 and when he returned he did not believe the business situation was favorable, due in part to the unsettled situation in Europe.

The net additions to plant and equipment of J. Robert Bazley, Inc., increased from $719,782.41 at April 30, 1939, which had been purchased by the use of the accumulation of earnings and profits since the organization of the business in 1930, to $1,051,933.03 at April 30, 1944.

On April 25, 1939, the board of directors of J. Robert Bazley, Inc., declared a dividend on the common stock of $14 per share, or a total of $70,000, which was paid in cash on April 28, 1939.

The earnings and dividends of J. Robert Bazley, Inc., for the fiscal years ending April 30, 1934, through and including 1944, were as follows:

Year Ending April 30	Earnings	Interest	Total	Dividends Paid	Dividends per Share
1934	$117,908			None	None
1935	(—4,828)			None	None
1936	106,891			$10,000	$10
1937	96,894			75,000	75
1938	6,578.17			65,000	65
Average for first five years	$ 64,688.634				
1939	104,178			70,000	14*
1940	1,528	$24,000	$ 25,528	10,000	2
1941	45,015	24,000	69,015	25,000	5
1942	43,884	24,000	67,884	15,000	3
1943	140,549	24,000	164,549	70,000	14
1944	102,890	24,000	126,890	70,000	14
Average for last five years			$ 90,773.20		

*Paid on the 5,000 shares issued in the recapitalization.

There was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds.

Respondent in his notice of deficiency increased the taxable incomes of petitioner and his wife by $319,200 and $80,400, respectively, "representing the fair market value of bonds of J. Robert Bazley, Inc., received in exchange of common stock of that corporation."

OPINION.

OPPER, *Judge:* It is respondent's position that although the exchange of the common stock held by petitioner in J. Robert Bazley, Inc., for new common stock and bonds of the same company conforms superficially to the provisions specifying non-recognition of gain, the transaction lacked a legitimate business purpose and hence fails to comply with the true statutory requirements. *Gregory v. Helvering*, 293 U. S. 465. Looking only at the language of the reorganization section, there was a technical recapitalization, that is, a reorganization within the statutory definition of section 112 (g) (1) (D). *Annis Furs, Inc.*, 2 T. C. 1096; *Clarence J. Schoo*, 47 B. T. A. 459, appeal dismissed (C. C. A., 1st Cir.). And since there was an exchange of stock for stock and securities in the same corporation, the language of the section forbids recognition of gain or loss. Section 112 (b) (3).

But that mere formal compliance is not sufficient, at least since the decision in the *Gregory* case. Hence the real issue is whether it has been satisfactorily established that there was a true business purpose for the operation by which petitioners were enabled to substitute for the entire outstanding stock of the corporation other stock possessing the same attributes and, in addition, instruments in the form of bonds representing newly-created fixed obligations of the corporation as to both principal and interest. A mere desire to effect a change in the form in which their property interests were held, but in such a manner as to escape the tax consequences otherwise called for, would not under the *Gregory* case furnish the necessary validating purpose. *Louis Wellhouse, Jr.*, 3 T. C. 363. In that situation it would be of no consequence whether the transaction should be treated in part as an exchange of stock for stock

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[1] Internal Revenue Code.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) Exchanges Solely in Kind.—

* * * * *

under section 112 (b) (2) since no claim is made that any gain was realized upon that phase of the transaction. If in course of the surrender, cancellation, and redemption of the old stock and the issuance of the new stock and bonds, petitioners received a distribution which was essentially equivalent to the declaration of a taxable dividend,[2] as respondent contends they did by means of the receipt of the bonds, the fair market value of that distribution would be taxable to them as a dividend under the provisions of section 115 (g).

Thus, in *Edith B. Bass*, 45 B. T. A. 1117, we held under somewhat similar circumstances that the redemption of stock of the taxpayer, accompanied by the issuance of other stock, was in part essentially the equivalent of a taxable dividend. This decision, it is true, was reversed (C. C. A., 1st Cir.), 129 Fed. (2d) 300, but upon the reasoning that since there was no effort there to capitalize accumulated earnings and the earned surplus remained available for future dividend action on the part of the corporation, the similarity to a dividend disappeared. The Court said in part (304, 305, 309):

> * * * Congress itself has defined the term "dividend" in § 115 (a) of the Act as meaning any *distribution* made by a corporation to its shareholders, whether in money or in other property, *out of its earnings or profits*. * * *
>
> * * * * * * *

"(2) Stock for stock of same corporation.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation."

[2] Internal Revenue Code.

"SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * *

"(g) Redemption of Stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

Whether profits are to be capitalized is not a mere matter of bookkeeping; there are important business differences according as one course or the other is pursued. If profits are capitalized by means of a stock dividend such profits are no longer available for the declaration of a dividend at the discretion of the directors but become part of the permanent capital of the corporation, thereby tending to enhance the corporation's credit. If profits are not capitalized they may be distributed as dividends some time in the future; and it would be a contradiction in terms to say there has been in any sense a "distribution" out of "earnings or profits" when such earnings have been expressly held intact in the surplus account for possible future distribution.

* * * * * *

Gregory v. Helvering, 1935, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596, 97 A. L. R. 1355, cited by the Board, is no authority for the position taken. * * * In substance, assets of the corporation were distributed to its shareholders and the corporation's surplus was correspondingly reduced. In these circumstances the distribution was held taxable as a dividend. In the case at bar, however, there was a permanent revision of the capital structure pursuant to a plan of recapitalization having a genuine business purpose. The transaction was not a tax-dodging subterfuge. There was in fact no "distribution" out of "earnings or profits."

* * * * * *

* * * Of course, the fact that there has been no increase in the aggregate wealth of the shareholders does not in itself establish that they have not received a dividend. United States v. Phellis, 1921, 257 U. S. 156, 171, 42 S. Ct. 63, 66 L. Ed. 180. On the other hand, neither does this fact establish that the stockholders *have* received a dividend. On that issue the fact is colorless. What distinguishes the present transaction

from a stock dividend is that here no portion of the surplus was capitalized.

Under the present facts this reasoning would be inapplicable. Not only did the issuance of fixed obligations inevitably capitalize and imprison a corresponding amount of earned surplus, by reason of the proportionate increase in liabilities as compared with assets and the consequent reduction of surplus; but a specific and declared purpose of the operation was to incorporate in the bonded indebtedness the company's investment in machinery and equipment which was recognized to have been paid for out of accumulated earnings.[3] If the principles upon which the *Bass* case was reversed are followed and the test there designated is applied, the result thus remains the same. Cf. *Louis Wellhouse, Jr., supra*. The elimination by the process here adopted of an equivalent segment of accumulated earnings which would otherwise have been available for the declaration of subsequent dividends requires that this action itself be characterized as a distribution out of earnings and hence as the equivalent of the declaration of a taxable dividend.

On the present record and upon detailed review of all of the aspects urged on behalf of petitioners, we have felt compelled to the conclusion set forth in our findings of fact that no legitimate corporate business purpose existed for the so-called recapitalization. Such objectives as to create a security more desirable for the stockholders as being less fluctuating in value, more regular and certain in its income, easier to market for inheritance tax payments and furnishing greater safety against claims of corporate creditors are

[3] "Yes, at this time the fixed assets of the corporation were very large in relation to the amount of stock outstanding—that is, to the face value of the stock, due to the fact that there had been an accumulation of profits that had all been turned back into the business, new equipment purchased.

"We might add that the equipment used in this particular type of work is very expensive and requires a great deal of working capital. * * *

"* * * so these fixed assets were here and had been built through accumulation, and it seemed very advisable to reflect this accumulation of earnings in the permanent dedication of these funds and put it into corporation use." Testimony of petitioner, J. Robert Bazley.

easily understandable from the standpoint of the stockholders. They furnish persuasive reasons why the stockholders wanted to change the form of their investment. But, as we have said, a desire to encompass such an exchange without occasioning the tax consequences usually attendant upon those transactions would not supply the necessary purpose as a business or corporate object. And certainly it would be a contradiction in terms to agree with petitioner that the desire to incorporate the undistributed profits into invested capital so as to render them immune from future invasion could be such a business purpose when this very act can be regarded as creating the resemblance to a dividend which the statute subjects to tax. *Bass v. Commissioner, supra.*

The purpose most insistently advanced as justifying the exchange was the asserted desire to make the new stock available in larger volume and smaller units for distribution among key employees whose interest in the company it was desired to retain. Such an object would be acceptable as a legitimate purpose of the corporate business. *Jacob Fisher,* 46 B. T. A. 999. But we are unable to satisfy ourselves that such a purpose was ever in fact entertained. After five years, the distribution has never taken place. And no excuse advanced to justify the delay is convincing. Every one points rather in the direction of the assumption that one or another of the same reasons can always be resorted to to cause a further postponement. And most suggest that if valid, they should have operated to postpone or prevent the "recapitalization" itself, rather than the subsequent distribution.

Thus it is suggested that in the spring of 1939, when the new stock became available, the company's contracts were up for renewal, in the fall the European war commenced, by the following spring the company's earnings statement was unfavorable, and by the end of 1941 this country itself entered the war. But the contract situation was known before the new stock was authorized; the out-

break of war was a factor in the business picture, both uncertain in its effect and typical of other business hazards; the coal business was known to be "up and down"; and the average earnings for the significant years and particularly those for fiscal 1941 are not appreciably at variance with the figures for the company's previous history.

The hazardous nature of the road building business upon which the company was about to embark furnishes an adequate ground for the apprehension on the part of the stockholders which led to the partial transformation of their investment into fixed obligations, but it is diametrically at variance with the assumption that at the same time the earnings could be so stable and secure as to meet the stated prerequisite for participation on the part of the employees. Finally, the increased corporate earnings since the entry of this country into the war would seem to furnish the anticipated inducement to institute the plan at least by that time, and the fear that war bond purchases might suffer is hard to credit. We are consequently forced to the conclusion that the undisputed facts speak with a clearer voice than the unsupported testimony of petitioner; and that since the two are inconsistent, the former must shape our ultimate decision. We have accordingly found a complete absence of legitimate corporate business purpose within the *Gregory* principle.

Such cases as *Clarence J. Schoo, supra, Edgar M. Docherty*, 45 B. T. A. 462, appeal dismissed (C. C. A., 1st Cir.), and *Annis Furs, supra*, may be distinguished from the present proceeding on grounds similar to those upon which *Jacob Fisher, supra*, was distinguished from *Edith B. Bass, supra*. Here, as in the *Bass* case, "the record fails to disclose any business purpose of substance" in the transaction. Without attempting to set out the details appearing in the facts of the various cases cited, it is enough to say that in each a benefit to the corporation of greater or less consequence appears as an anticipated result of the reorganizations there undertaken. In the present proceed-

ing, as we have found, the benefits to the business are negligible and insubstantial. The individual stockholders may well have endeavored to establish a foundation for participating in the corporate profits without subjecting the distributions to taxation as dividends. For a subsequent redemption of the bonds would not only fail to qualify as the equivalent of a taxable dividend under 115 (g) but would fall precisely within the terms of section 117 (f) as an item of capital gain,[4] with the accompanying limitations on taxability.[5] But such a purpose, if it existed, would fail to release the operation from the rule in the *Gregory* case. "Putting aside, then, the question of motive in respect of taxation altogether * * * what do we find? Simply an operation having no business or corporate purpose * * * not to reorganize a business or any part of a business, but to transfer a parcel of corporate * * * [securities] to the petitioner."

Reviewed by the Court.

Decision will be entered for the respondent.

DISNEY, *J.*, concurs only in the result.

BLACK and TYSON, *JJ.*, dissent.

SMITH, *J.*, dissenting: The majority opinion recognizes that on the facts there was a "technical" recapitalization and reorganization of J. Robert Bazley, Inc. in 1939 but holds that the reorganization lacked "a legitimate business purpose" and therefore must be denied recognition for tax purposes, under the doctrine of *Gregory v. Helvering*, 296 U. S. 465.

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[4] Internal Revenue Code, section 117 (f).

"(f) Retirement of Bonds, Etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

[5] Internal Revenue Code, section 117 (a).

In the *Gregory* case the court disregarded, as a mere sham, a corporate entity which was created for the sole purpose of effecting a tax-free transfer of corporate assets to stockholders and which was dissolved immediately after it had served its purpose in carrying out the artifice.

I do not think that the principle of the *Gregory* case is applicable here. It seems to me that the evidence shows a legitimate business reason, perhaps several legitimate business reasons, for the recapitalization. Some of those reasons are plainly set out in the findings of fact. The evidence discloses a further reason, which is not shown in the facts; namely, that under the recapitalization there was set up the basis for an annual deduction of $24,000 of interest on the debenture bonds which were issued in exchange for common stock. Petitioner J. Robert Bazley testified:

> A. Furthermore, it seemed to us in conference with this management, that this plan of issuing common stock and debentures would also secure for the corporation certain benefits inasmuch as the fixed charges on the bonds would have the purpose of reducing Federal and State taxes, and it would also enlarge the percentage of dividends on the reduced value of the stock inasmuch as the value of the stock had been reduced.

It seems to me that this reason alone, that is, the reduction of taxable income, might be deemed sufficient to give substance to the recapitalization. The court observed in the *Gregory* case that: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted," citing *United States v. Isham*, 17 Wall. 496; *Superior Oil Co. v. Mississippi*, 280 U. S. 390; *Jones v. Helvering*, 71 Fed. (2d) 214.

In *Commissioner v. Capento Securities Corporation*, 140 Fed. (2d) 382, the Circuit Court of Appeals for the First Circuit held, affirming 47 B. T. A. 691, that the issuance by a corporation of its preferred stock for its out-

standing bonds constituted a recapitalization, and therefore a statutory reorganization. The purpose of the recapitalization there, which was held to be a legitimate one, was to facilitate the securing of loans from the banks. Distinguishing *Gregory v. Helvering, supra*, where "the purported 'reorganization' though following the literal language of the statutory definition, was an operation having no business or corporate purpose," the court observed that:

> * * * There resulted a permanent revision of the capital structure of Raytheon Production Corporation pursuant to a plan of recapitalization—a normal business procedure dictated by the necessity of raising new capital. In such circumstances it is the purpose of the nonrecognition provisions of the Act to save the taxpayer from an immediate recognition of a gain, where, in a popular and economic sense, there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, though a gain may have accrued in a constitutional sense. * * *

See also *Bass v. Commissioner* (C. C. A., 1st Cir.), 129 Fed. (2d) 300.

I think that the finding of the Tax Court in this case that the reorganization of *J. Robert Bazley, Inc.* lacked a true business purpose is contrary to the evidence.

ARUNDELL and VAN FOSSAN, *JJ.*, agree with this dissent.

DECISION.

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, promulgated February 28, 1945, it is

ORDERED and DECIDED: That there is a deficiency in income tax of $214,170.52 for the year 1939.

(Signed) CLARENCE V. OPPER,
Judge.

Enter:

Entered: Mar. 2, 1945.

Copies served on both parties.

[fol. 106] UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1945

No. 8947

J. ROBERT BAZLEY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appeal from the Decision of the Tax Court of the United States

Argued November 20, 1945

Before Biggs, McLaughlin and O'Connell, Circuit Judges

OPINION OF THE COURT—Filed January 8, 1946

By O'CONNELL, Circuit Judge:

This is a petition to review the decision of the Tax Court of the United States sustaining the Commissioner's determination of deficiencies in the income tax of J. Robert [fol. 107] Bazley for the year 1939.[1] The question for our determination is whether the petitioner is properly chargeable with having received ordinary income during the taxable year to the extent of the face value of certain bonds of J. Robert Bazley, Inc., distributed to petitioner in that year.

Shortly prior to February 1, 1939, J. Robert Bazley, Inc., was engaged in general heavy contracting business with most of its operations consisting of coal mining by the open-pit method. The corporation's stock was owned by J. Robert Bazley, Alice H. Bazley, his wife, and Alfred Day, all of whom constituted the Board of Directors. On February 16, 1939, owners of the outstanding capital stock of the corporation held a special meeting pursuant to resolutions adopted by the board of directors on February 6, 1939, and

[1] The Tax Court also decided substantially the same question as that involved herein but relating to Alice H. Bazley, wife of the petitioner. A petition for review of the Tax Court's decision with respect to her 1939 tax liability is also pending but, by stipulation approved, the judgment in the case at bar is controlling in the case of Alice H. Bazley.

formally approved a proposed plan of reorganization. Resolutions authorizing the necessary corporate action for consummation of this plan were passed. On March 6, 1939, the Commonwealth of Pennsylvania approved the amendments to the Company's Articles of Incorporation increasing the authorized common stock.

The reorganization is reflected in the table set forth below which indicates stock ownership and capitalization of the corporation before and after the occurrence of the transaction under scrutiny here.

	Old	New	
Name	Shares	Shares	Debenture Principal Amount
J. Robert Bazley	798	3,990	$319,200.00
Alice H. Bazley	201	1,005	80,400.00
Alfred Day	1	5	400.00
Total	1,000	5,000	$400,000.00

[fol. 108] Capital Structure of Corporation

February 1, 1939 (Before proposed reorganization)

1,000 shares common stock par value of $100 per share	$100,000.00
Earned Surplus	855,783.82
	$955,783.82

March 16, 1939 (after reorganization)

Outstanding Debenture Bonds	$400,000.00
5,000 shares common stock without nominal or par value, the stated capital applicable to which is	300,000.00
Earned Surplus	255,783.82
	$955,783.82

On March 16, 1939, the stockholders delievered their 1,000 shares of odd common stock to the corporation and received from the corporation the 5,000 shares of the new common stock and debenture bonds in the aggregate principal

amount of $400,000. The old common stock was cancelled by the corporation.

The Tax Court found[2] there was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the "recapitalization" resulting in the issuance and distribution to the stockholders of $400,000 in debenture bonds. According to the testimony, it appears that the corporation was contemplating entry into road building work, a financially hazardous business and one requiring considerable working capital. The following reasons motivated the recapitalization: (1) the stockholders, by obtaining debenture bonds for their stock, would receive a more readily marketable and less fluctuating security in case it would become necessary for the estate of a deceased shareholder to liquidate his investment to meet inheritance taxes or for other purposes; (2) the bonds could be sold without reducing the Bazley family's stock control of the corporation; (3) the contemplated entry into the hazardous business of road construction made it desirable for stockholders to possess bonds in order to be in a position at least equal to general creditors in the event of insolvency; (4) the value of the corporation's plant and equipment ($719,782.41 as of April 30, 1939) was large as compared with its capitalization of $100,000, and since such equipment had been purchased by using funds acquired through accumulation of $855,783.07 of earnings and profits, it was deemed advisable to reflect a dedication of these earnings to corporate use by reducing surplus available for dividends and transferring a part thereof to capital stock and a part to long-term debt represented by the 20-year bonds. Two additional motives advanced by the petitioner as reasons for the questioned transaction were (a) to provide stock of a type available for sale to the company's key employees and (b) to reduce the company's taxable income by $24,000 through the interest payments on the debenture bonds. The majority of the Tax Court refused to accept these two purposes as having existed in fact[3] and, on the whole record, concluded that

[fol. 109]

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[2] Five judges dissenting.

[3] The Tax Court was greatly influenced in the rejection of the first of these two asserted motives by the fact that the Bazleys, after five years, have never made any distribution of the new common stock to key employees and that

[fol. 110] no legitimate corporate business purpose existed for the recapitalization.

The Commissioner contends that the distribution of the $400,000 face value 20-year debenture bonds constituted a taxable dividend. No attempt is made to impose a tax on any part of the new stock distributed to the petitioner.

Petitioner asserts that the entire transaction was in pursuance of a *bona fide* corporate reorganization in the nature of a "recapitalization" [Section 112(g) (1) (E)[4]] and therefore tax-free under the provisions of Section 112. (b) (3),[5] or if by reason of the absence of a legitimate corporate business purpose the transaction is not a reorganization, it is an exchange of stock for stock and other property under Section 112 (b) (2) and thus taxable only as capital gain under Section 112 (c) (1) and 117.[6]

The issue here is sharply defined: The Commissioner maintains that, absent a legitimate corporate business purpose, there can be no tax free reorganizational transaction, under the doctrine of Gregory v. Helvering, 293 U. S. 465 (1935). Petitioner, however, argues that the *Gregory* deci-

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proffered excuses for such failure to carry through the asserted intention lacked plausibility. As to the other asesrted motive the majority opinion is silent. Judge Smith, dissenting, felt that the evidence disclosed a legitimate corporate business purpose in the reduction of taxable income of the corporation by payment of $24,000 annual interest on the debenture bonds. The reasoning of the majority of the Court in rejecting this as a motive in fact for the corporation's recapitalizing may be found in the later decision of the same court with a similar dissent in Adair A. Adams, 5 T. C. 351 promulgated June 29, 1945. There, the majority of the Tax Court pointed out the obvious *disadvantage to the corporation* in undertaking an annual obligation to pay interest on a substantial sum of money in order to obtain a tax reduction in a much smaller amount. For the purposes of this case, the fact findings do not include one that the corporation's motive in effecting the recapitalization was to reduce Federal income taxes.

[4] 26 U. S. C. (1940 ed.) Sec. 112 (g) (1) (E).

[5] 26 U. S. C. (1940 ed.) Sec. 112 (b) (3).

[6] 26 U. S. C. (1940 ed.) Sec. 117.

sion is inapplicable where there exists a legitimate business purpose of the *stockholders* for the reorganization ("reasons other than tax avoidance", to use the petitioner's phrase).

It is true that, literally, the questioned transaction is a "recapitalization". But the sanctuary of the tax free "reorganization" is not available to a taxpayer merely because the form of the transaction matches literally, the wording of the Revenue Act. What Judge Goodrich said in Commissioner v. Gilmore's Estate, 130 F. 2d 791, 794 (C. C. A. 3, 1942) is here pertinent: "It is now settled that whether a transaction qualifies as a reorganization under the various Revenue Acts does not turn alone on compliance with the literal language of the statute. The judicial interpretation has determined that something more may be [fol. 114] needed and that, indeed, under some circumstances, something less will do. Our concern in this case is the 'something more' since we have concluded that there was a literal compliance. The starting point is Gregory v. Helvering, 1935, 293 U. S. 465."

As we view the *Gregory* decision, the taxpayer's motive to avoid taxation by the questioned device is not the test. The true inquiry questions the connection between the corporation's business interests and the transaction under scrutiny. In short, the petitioner confuses the shareholders' objective in assenting to the transaction with the corporation's purpose in accomplishing it; *cf.* Chisholm v. Commissioner, 79 F. 2d 14, 15 (C. C. A. 2, 1935); certiorari denied, 296 U. S. 641 (1935), where Judge Learned Hand who wrote the opinion affirmed by the Supreme Court in the *Gregory* case [7] pointed this out, referring to the accompanying purpose to escape taxation as a "legally neutral" fact.

Analysis of the numerous cases which follow *Gregory* reveals that they turn on whether or not what was accomplished by the questioned transaction was designed to meet a corporate "business exigency": see, for example, Commissioner v. Gilmore's Estate, *supra*; and Commissioner v. Capento Securities Corp., 140 F. 2d 382 (C. C. A. 1, 1944), in which a legitimate corporate business purpose existed for the "reorganization" and the transaction questioned in each was upheld as a tax free "reorganization" within the mean-

[7] Helvering v. Gregory, 69 F. 2d 809 (C. C. A. 2, 1934).

ing of the Revenue Acts.[8] The quest for a legitimate business purpose of the corporation in effecting the "reorganization" has been made consistently by the Tax Court as well: see, for example, Marion Healy, T. C. Dkts. 5812-5813 promulgated July 24, 1945; Adam A. Adams, 5 T. C. 351 (1945); Louis Wellhouse, 3 T. C. 363 (1944); and Jacob Fisher, 46 B. T. A. 999. The Treasury Regulations, also, [fol. 112] embody this concept: Reg. 103, Sec. 19, 112 (g)-1, 112 (g)-2.

Accordingly, we must look for such a legitimate business purpose of the corporation as distinct from the mere personal desires of the shareholders. The Tax Court expressly found that there was no such corporate business purpose for the "recapitalization" in this case. Our review of the record reveals substantial support of this finding.

The precise question for our determination is thus whether the distribution of the debenture bonds following the cancellation of the old common stock occurred "at such time and in such manner as to make the distribution and cancellation . . . . essentially equivalent to the distribution of a taxable dividend . . . .": Internal Revenue Code, Sec. 115 (g).[9] No "sole decisive" test for such a determina-

[8] As Judge Goodrich pointed out in the Gilmore case, the Gregory decision does not go so far as to require a legitimate corporate business purpose for the particular method used to accomplish what in fact was done by a "reorganization". It is sufficient if *what was accomplished* by the "reorganization" met a corporate "business exigency".

[9] 26 U. S. C. (1940 ed.) Sec. 115 (g).

> "(g) Redemption of Stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

So far as the issuance to the petitioner of the common stock is concerned, the table in the text shows that no change

tion has been laid down either by the Tax Court or the appellate courts: Flanagan v. Helvering, 116 F. 2d 937 (App. D. C. 1940), per Vinson, J. The history of Section 115 (g), beginning with the Acts of 1926, throws some light on the desired objective of Congress in passing such legislation. In the House, Senate and Conference Reports [10] an [fol. 113] illustration of the type of situation intended to be covered by this section was given thus: Suppose "... the case of two men holding practically the entire stock of a corporation for which each paid $50,000. The corporation, having accumulated a surplus of $50,000 above its cash capital, buys from the stockholders for cash one-half the stock held by them and cancels it, and the payment is non-taxable because it is a partial redemption of stock. To change this result and make it taxable [Sec. 115] (g) was written and incorporated into the law." [11]

We see no real distinction between a case where the corporation pays cash for its outstanding stock and where the corporation pays in the form of debenture bonds for its old stock: see Doerschuck v. United States, 274 Fed. 739 (E. D. N. Y. 1921). In each case the application of Section 115 (g) to the transaction under scrutiny depends on the particular facts. McGuire v. Commissioner, 84 F. 2d 431 (C. C. A. 7, 1936); certiorari denied, 299 U. S. 591 (1936).

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in proportional ownership took place and, under the circumstances, distribution of the new common stock could not be regarded as "essentially equivalent to the distribution of a taxable dividend": *cf.* Eisner v. Macomber, 252 U. S. 189, 211 (1919); but *cf.* Bass v. Commissioner, 129 F. 2d 300, 304, 305 (C. C. A. 1, 1942).

[10] H. Rep. No. 1, 69th Cong., 1st Sess. p. 5; S. Rep. No. 52, 69th Cong., 1st Sess. p. 15; H. Conference Rep. No. 356, 69th Cong., 1st Sess. p. 30.

As pointed out in f. n. 3 of Flanagan v. Helvering, *supra*, the illustration was made in connection with the Act of 1926, Sec. 201 (g), 44 Stat. 11, 26 U. S. C. A., Int. Rev. Acts, page 147. In relevant portions this is identical with the corresponding section of the 1939 Revenue Act, 26 U. S. C. (1940 ed.) Sec. 115 (g).

[11] For an example of the applicability of the illustration to an actual case, see Hyman v. Helvering, 71 F. 2d 342 (App. D. C. 1934); certiorari denied, 293 U. S. 570 (1934).

Moreover, the question of whether a distribution in connection with the cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend is one of fact: Brown v. Commissioner, 79 F. 2d 73 (C. C. A. 3, 1935); Commissioner v. Champion, 78 F. 2d 513 (C. C. A. 6, 1935); Commissioner v. Babson, 70 F. 2d 304 (C. C. A. 7, 1934); Randolph v. Commissioner, 76 F. 2d 472 (C. C. A. 8, 1935); Hirsch v. Commissioner, 124 F. 2d 24 (C. C. A. 9, 1941). Consequently, we are powerless to disturb the Tax Court's determination of such a factual question if substantial evidence to support its conclusion exists: Helvering v. Kehoe, 309 U. S. 277 (1940). Nor will we controvert the Tax Court's determination by "treating as questions of law what really are disputes over proper accounting": see Dobson v. Commissioner, 320 U. S. 489, 499 (1943).

As we view the record in this case, there is not only substantial evidence to support the Tax Court's determination but, indeed, it would be difficult to reach any other con- [fol. 114] clusion. Under Section 115 (a) [12] a distribution out of accumulated earnings and profits is a "dividend". "Recapitalization does not alter the 'effect' ": Commissioner v. Estate of Bedford, 325 U. S. 283, 292 (1945). The net worth of the corporation, i. e., the value of the stock in the hands of the stockholders, prior to the reorganization, was $955,783.82. This value, after reorganization, was $555,783.82. Clearly, the corporation has thus distributed $400,000 out of accumulated earnings and profits. The face and market value of the bonds is admittedly $400,000. By their distribution to the stockholders, the corporation

[12] 26 U. S. C. (1940 ed.) Sec. 115 (a)

"(a). *Definition of Dividend.*—The term 'dividend' when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913; or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

effectively consumed that much of the earned surplus which would otherwise be available for declaration of subsequent dividends. Petitioner admits this.

To issue bonds, it would not have been necessary to adjust the value of the capital stock ($100,000) on the books of the corporation. Normally, the bonds would have been sold for cash, in which event no charge would have been made against earnings. But had the normal procedure been followed, to transfer the cash into the hands of the stockholders would necessitate a declaration of a dividend with the consequent tax to the recipient. Such dividend would be a charge against earnings. Consider what was accomplished here: The same results were obtained. Instead of the stockholders paying cash into the treasury of the corporation and subsequently receiving an equivalent amount back, the bonds were distributed directly to the stockholders on the same basis as if declared as a dividend. But to accomplish the actual transfer of the bonds to the stockholders without technically declaring a dividend, the plan of can- [fol. 115] celling the old stock was adopted. This distribution by the corporation of other property (the bonds) out of its earnings and accumulated profits as a result of the cancellation of its old stock, was thus made in such manner as to make the distribution and cancellation essentially equivalent to the distribution of a taxable dividend.

In connection with the application of Section 115(g) to this transaction, we need not inquire into motive. The "basic criterion" is the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation: Smith v. United States, 121 F. 2d 692 (C. C. A. 3, 1941). Here, as pointed out above, the net effect of the distribution of the debenture bonds was to distribute to the petitioner a substantial segment of the previous earnings of the corporation: *cf.* Commissioner v. Estate of Bedford, supra.[13]

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[13] In the Bedford case, there was a *bona fide* "recapitalization-reorganization" which was effective to make tax free the receipt of stock by the taxpayer under Sec. 112 (b) (3), Sec. 112 (c) (1), 26 U. S. C. (1940 ed.), Sec. 112 (b) (3), Sec. 112 (c) (1). Obviously, this case is a much stronger one for imposing a tax than the "seemingly similar situation" where two corporations are involved and where the net

Petitioner, however, contends that the transaction here under consideration must be viewed as a whole. He asserts that it cannot be "split up" into two steps, (1) a cancellation of the old stock, and (2) a distribution of the debenture bonds.

[fol. 116] Following this reasoning, he insists the transaction was an exchange under Section 112 (b) (2) and Section 112 (c) (1) [14] and consequently taxable only as a capital gain under Section 117.[15] The full answer to this contention is found in Dobson v. Commissioner, 320 U. S. 489, 502 (1943), where the Supreme Court stated, "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more

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effect is to transfer earnings of one corporation to another and then to distribute out of the second corporation's assets. In that type of case, "Where one corporation acquired the assets of another corporation in a tax-free reorganization it is well settled that the earned surplus of the transferor becomes earned surplus of the transferee and is subject to taxation as a dividend on subsequent distribution to the stockholders of the transferee": Putnam v. United States, 149 F. 2d 721, 726 (C. C. A. 1, 1945), applying the doctrine of Commissioner v. Sansome, 60 F. 2d 931 (C. C. A. 2, 1932), certiorari denied 287 U. S. 667 (1932), which we followed in Corrigan v. Commissioner, 103 F. 2d 1010 (C. C. A. 3, 1939), certiorari denied 308 U. S. 576 (1939). For other cases in the long line following the Sansome decision, see f. n. 5 to Putnam v. United States, *supra*, at p. 726.

Furthermore, in determining whether there has been a "distribution of a taxable dividend", it is immaterial whether the distribution occurs after an exchange of stock and assets of two corporations as in Commissioner v. Sansome, *supra*, or whether the assets of one corporation only are involved: See Commissioner v. Estate of Bedford, *supra*, page 291.

[14] 26 U. S. C. (1940 ed.) Sec. 112 (b) (2), Sec. 112 (c) (1).

[15] 26 U. S. C. (1940 ed.) Sec. 117.

reviewable than any other question of fact." Consequently, we are required to view this transaction like the Tax Court did, as one involving a cancellation of old common stock followed by a distribution of the 20-year debenture bonds. And upon the reasoning already announced, we conclude that such distribution is taxable as a dividend under Section 115 (g): *cf.* Smith v. United States, 121 F. 2d 692 (C.C.A. 3, 1941).

The decision of the Tax Court is affirmed.

A true Copy: Teste:

_____, Clerk of the United States Circuit Court of Appeals for the Third Circuit.

[fol. 117] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1945

No. 8947

J. ROBERT BAZLEY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Present: Biggs, McLaughlin and O'Connell, Circuit Judges.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

By the Court, John J. O'Connell, Circuit Judge.

January 8, 1946.

Endorsements: Order Affirming Decision of U. S. Tax Court. Received & Filed Jan. 8, 1946. Wm. P. Rowland, Clerk.

[fol. 118] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 8947

J. ROBERT BAZLEY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

MOTION TO EXTEND TIME FOR FILING PETITION FOR REHEARING

Now comes, the Petitioner, by his counsel, Henry S. Drinker and Frederick E. S. Morrison, and respectfully moves that the time within which Petition for Rehearing in this proceeding may be filed be extended thirty days to February 21, 1946. The opinion of the Court in this case was filed on January 8, 1946, so that the Petition for Rehearing under Rule 35 should be filed on or before January 23, 1946.

The pressure of income tax matters caused by the conjunction of preparing income tax returns for the clients of petitioner's counsel for filing on both January 15th and March 15th, has been and will be such that petitioner's counsel cannot properly prepare Petition for Rehearing in the time provided by the rules, and accordingly thirty days of additional time is respectfully requested.

(S.) Henry S. Drinker, Frederick E. S. Morrison,
1429 Walnut Street, Philadelphia 2, Pa.

Approved Goodrich, J. Jan. 19, 1946.

[fol. 119] [Endorsed:] In the United States Circuit Court of Appeals for the Third Circuit. No. 8947. J. Robert Bazley, Petitioner, v. Commissioner of Internal Revenue, Respondent. Motion to Extend Time for Filing Petition for Rehearing. Henry S. Drinker, Frederick E. S. Morrison.

[fol. 120] Table of Cases Cited

	Original
Bingham's Trust v. Commissioner, 65 S. Ct. 1232	6, 7
Commissioner v. Capento Securities Corp., 140 F. (2d) 382	4
Commissioner v. Gilmore's Estate, 130 F. (2) 791, 795	3
Dobson v. Commissioner, 320 U. S. 489	5
Doerschuck v. U. S., 274 Fed. 739	6
Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266	2, 3, 4
Smith v. U. S., 121 F. (2d) 692	3
Wellhouse v. Commissioner, 3 T. C. 363	3

Statute Cited

Internal Revenue Code, 53 Stat. (Part 1); 26 U. S. C. A.:	
Section 111, 53 Stat. 37	1
Section 112(a), 53 Stat. 37	1
Section 112(b)(2), 53 Stat. 37	1
Section 112(b)(3), 53 Stat. 37	1
Section 112(c)(1), 53 Stat. 39	1, 5
Section 115, 53 Stat. 46	1
Section 115(a), 53 Stat. 46	8
Section 115(g), 53 Stat. 48	1, 7
Section 117, 53 Stat. 50	1, 5

[fol. 121] Petition for Rehearing

Comes now the above-named Petitioner, J. Robert Bazley, and presents this, his Petition for Rehearing of the above-entitled cause, and in support thereof, respectfully shows:

1. On January 8, 1946, this Court filed its opinion herein affirming the decision of the Tax Court of the United States that Petitioner, upon the receipt of $319,200. face amount of debenture bonds and 3,990 shares of new no-par common stock of J. Robert Bazley, Inc., in exchange for his 798 shares of $100 par value common stock of the same corporation, realized a taxable dividend as to such bonds under Section 115(g) of the Internal Revenue Code, and that Petitioner's income tax deficiency thereon amounted to $214,172.52. The Court denied Petitioner's contentions:

(1) That upon such exchange the bonds so received by him were not a dividend within any provision of Sec. 115 since the exchange was a tax-free "reorganization" (recap-

italization) exchange under the Code Provisions of Sec. 112(b)(3) OR, in the alternative:

(2) That even though the Tax Court found that such "exchange" needed but lacked, "a corporate business purpose", to constitute a "reorganization" as that term is used in Sec. 112(b)(3), it was nevertheless, an exchange (as Respondent admitted in both his Answer and Brief and as the Tax Court found) and hence fell squarely within the precise provisions of Secs. 111 and 112(a) and was taxable only to the extent as provided by Secs. 112(b)(2) and (c)(1) and limited to the capital gains tax rate as provided in Sec. 117.

[fol. 122] 2 Rehearing is sought on the following grounds:

I

On the First Contention—whether a corporate business purpose is essential to a tax-free "reorganization":

(1) The Tax Court did not find that the "exchange" was in any sense a "sham" or ineffective to result in the valid issue of the new stock and debentures "in exchange for" the old stock. On the contrary, it found that the new securities were validly issued and are permanently outstanding in the hands of the holders, whose proportionate interests in the Corporation are precisely the same as prior thereto. On p. 28 of his brief in this Court, the Commissioner says:

> "It is not disputed that the new common stock and debentures issued in the recapitalization were real and gave the recipients the rights in the corporation which they purported to do as taxpayer argues (Br. 36). But the question here is whether what was done was inspired by purposes having a substantial relation to the Corporation's business, so that the recapitalization may be given effect for tax purposes."

(2) The Tax Court's conclusion that a corporate business objective was necessary as distinguished from one beneficial only to the stockholders was not based on a construction by it of the statute or of any document, but on its interpretation of the decision of the Supreme Court in the *Gregory* case. This involved the clearest and purest imaginable question of law.

(3) The phrase in the *Gregory* case which the Tax Court has construed to mean a legitimate corporate business purpose was a business *or* corporate purpose. It is submitted that if the Supreme Court had intended to draw a distinction between a purpose of the corporation and one [fol. 123] of its stockholders, it would have said "corporate business purpose", or "purpose of the corporate business". The Tax Court's construction of the phrase ignores the Supreme Court's use of the disjunctive "or", and, for that matter, the words "business or" since a corporation can have no purpose except the furtherance of its business for the benefit of its stockholders.

(4) In its decision, this Court expressly stated that the test was not the taxpayer's motive, but the result attained. (See also *Smith v. U. S.*, 121 F. 2d 692.) Irrespective of the genuineness of the stockholder's motive in obtaining a greater number of shares of lesser value per share for actual sale by him to key employees, the corporation, by means of the recapitalization, created shares which would be available for such sale by the stockholders when this seemed advisable, a result of obvious advantage to the corporation.

(5) The distinction between a legitimate *corporate* business purpose and one benefitting the *stockholders* has not, it is submitted, been made consistently by the Tax Court, since the decision in the *Gregory* case, as intimated at the bottom of page 6 of this Court's printed opinion.

This supposed distinction was invented by Judge Disney of the Tax Court in a dictum in the *Wellhouse* case, 3 T. C. 363, Feb. 28, 1944, as an interpretation of a dictum in the *Gregory* case more than nine years before. It was first actually applied by the Tax Court in the decision of the case at bar. The Treasury regulations referred to by this Court do not, it is submitted, refer to the necessity of a *corporate* business exigency, but merely to a business exigency, which means that the transaction is a genuine one, and effected for reasons other than avoidance of a tax which is "imminent".

Nor did this Court in the *Gilmore* case (130 F. 2d) refer to the necessity of a *corporate* business purpose, but merely, [fol. 124] on page 795 to a "legitimate business result", a "legitimate business object", and a "genuine transaction"; on page 797 to "a reorganization in reality"; in note 13, to

"business exigency"; in note 14 to "legitimate business purposes". The word "corporate" was inserted by the Tax Court.

Similarly in *Carpento*, 140 F. (2d) 382, the Court does not refer to a "corporate business purpose" but, quoting the *Gregory* case, to a "business *or* corporate purpose" (page 385) and to "an ordinary business transaction."

(6) It is difficult to believe that this Court, in supporting the Tax Court's *construction* of the Supreme Court's reference to a business *or* corporate purpose as meaning "corporate business purpose" can have taken into consideration the legal complications which must necessarily follow, and the litigation which will result, in future cases involving recapitalizations. While in some of these cases, it will doubtless be possible to point to a more or less apparent corporate advantage, in the great majority of cases changes in the capitalization of a corporation are in reality advantageous only to the stockholders. For example, is there a demonstrable corporate advantage in the exchange of $100,000. par value 4% preferred stock and $100,000. par value of common stock for $80,000. par value 5% preferred and 1250 shares of no par common? If the rule here established be followed, it will set up a test of the validity of scores of recapitalizations so vague as to be wholly unpredictable, resulting in conclusion based on no substantial differences, in cases, all of which result in no change of continuity in control and in no present realization of actual gain to the stockholders, but merely in a change in the form of the security. Such a radical departure from long existing practice and legal standards should, it is submitted, be effected only by a prospective amendment to the law by Congress, or, at least, by the Supreme Court's own construction of its decision.

[fol. 125] II

On the second point—, that the admitted "exchange," if not tax-free, in any event was solely an "exchange" of stock for "stock and other property," under Sec. 112 (c) (1) and taxable under Section 117:

(1) Under *Dobson v. Commissioner*, 320 U. S. 489, it is clear that the Appellate Federal Courts are bound by the Tax Court's findings as to what are the primary facts. As stated in the quotation by this Court at the end of its

present opinion, such conclusive findings of primary facts include one as to whether an exchange of securities constitutes one integrated transaction or several separate steps.

(2) The Tax Court found expressly that the transaction in question was an *exchange* of the old common stock for the new common stock *and* the debenture bonds. In describing the plan of reorganization, it said:

> "The corporation was to issue *in exchange for the old stock*, the new stock *and* the debenture bonds * * *" (pp. 92a-93a).
>
> "*Pursuant to the plan*, the stockholders on March 16, 1939, delivered their 1,000 shares of common stock to the corporation and received from the corporation the 5,000 shares of its new common stock and debenture bonds in the aggregate principal amount of $400,000." (93a-94a) (emphasis supplied).

Paragraphs (5) and (6) of subdivision V of respondent's answer expressly admits (12a-13a) that the transaction was an *exchange* of the new stock *and* the bonds for the old stock.

At the end of the first paragraph of its opinion the Tax Court again characterizes the transaction as "*an exchange of stock for stock and securities* of the same corporation." [fol. 126] The Tax Court also found the facts in the stipulation (90a), paragraphs 10, 12 and 18 of which (16a-18a) stated that the shares of new common stock and the debenture bonds were issued by the company *in exchange* for the shares of $100 par stock previously outstanding.

(3) Under *Bingham's Trust v. Commissioner*, 65 S. Ct. 1232 (June 25, 1945) it is both the function and duty of the Federal Appellate Courts to correct the Tax Court's erroneous application of the law *to the facts found by that Court*.

(4) The Appellate Court can no more revise the Tax Court's primary findings of fact in order to *sustain* its legal conclusions than it can revise such primary findings in order to *upset* them.

(5) If the Tax Court had found from the evidence that the transaction *did not in fact* consist in an exchange of the old stock for new stock *and* bonds, but in fact consisted in an exchange of the old stock for the new stock, and that

the "distribution" of the bonds was in fact a separate transaction and not part of the exchange, this would be a wholly different case.[1] The Tax Court, however, did not so find, but found expressly that the issuance of the bonds was part of the unitary transaction which constituted the exchange.

(6) When this Court, at the end of its Opinion, states that the Tax Court viewed this transaction "as one involving a cancellation of old common stock *followed* by[2] a *distri-* [fol. 127] *bution* of the 20-year debenture bonds," this Court, it is respectfully submitted, did precisely what it states so clearly that this Court has no right and power to do,—it altered the Tax Court's own express finding of an essential fact in an endeavor to make such finding fit the legal conclusion which this Court sought to sustain.

(7) In the *Bingham* case, supra, the Supreme Court said (65 S. Ct. 1232, 1236):

> "Since our decision in the Dobson case we have frequently reexamined, as matters of law, determinations of the Tax Court of the meaning of the words of a statute as applied to the facts found by that court. A question of law is not any the less such because the Tax Court's decision of it is right rather than wrong."

Similarly, a finding of fact by the Tax Court is not any the less such because it does not support the legal con-

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[1] In *Doerschuck v. U. S.*, 274 Fed. 739, which involved the old Act of 1916, the bonds in question were distributed pro-rata to the stockholders out of the company's surplus earned since March 1, 1913. There was no "recapitalization" tax-free or otherwise, nor any exchange for new securities. The reorganization provisions were not included in the Act until 1918. The only question argued was whether the bonds were substantially equivalent to preferred stock, and the decision was that they were not.

[2] See also p. 7 of the Opinion where this Court speaks of the "distribution" of the debenture bonds as "following" the cancellation of the old common stock. The word "distribution," which implies a dividend, was not used by the Tax Court. It found that the bonds were issued *with* the new stock *in exchange* for the old common stock, a single transaction.

clusion at which the Tax Court or the Appellate Court would arrive.

(8) While the Tax Court states at the end of the first two passages quoted under (2) above, that the old stock was "cancelled by the corporation" after the exchange, under the primary facts found by the Tax Court, any such cancellation of the old stock *after* the exchange would, as a matter of law, have consisted merely of a physical mutilation of the old certificates. As a result of the exchange there was no reduction in the capital stock of the Corporation, either that authorized or that outstanding. In fact the capital stock was increased from $100,000 to $300,000.

(9) Admittedly the old stock was not "redeemed" by the corporation. It was doubtless for this reason,—recognizing that Section 115 (g) was not designed to cover and does not cover cases involving a recapitalization of a corporation's entire capital structure in a reorganization,—[fol. 128] that the Commissioner, in his brief in this Court (p. 30) repudiated the Tax Court's legal conclusion that this case came under that Section, and relied on Section 115(a), despite the Commissioner's admission and Tax Court's express finding that the debenture bonds were issued with the new stock, in exchange for the old stock.

Respectfully submitted, Henry S. Drinker, Frederick E. S. Morrison, Calvin H. Rankin, 1429 Walnut St., Philadelphia 2, Pa., for Petitioner.

Drinker, Biddle & Reath.

I certify that the foregoing petition is presented in good faith and not for delay,

Henry S. Drinker.

[fol. 129] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1945

No. 8947

J. ROBERT BAZLEY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

SUR PETITION FOR REHEARING

Present: Biggs, Maris, Goodrich, McLaughlin and O'Connell, Circuit Judges.

And Now, to wit, Feb. 14, 1946, after due consideration, the petition for rehearing in the above-entitled case is hereby granted, the rehearing to be before the court en banc.

Philadelphia, —— —, ——.

John J. O'Connell, Circuit Judge.

Endorsements: Order Granting Petition for Rehearing. Received & Filed, Feb. 14, 1946. Wm. P. Rowland, Clerk.

[fol. 130] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1945

No. 8947

J. ROBERT BAZLEY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ORDER

Present: Biggs, Maris, Goodrich, McLaughlin and O'Connell, Circuit Judges.

Now, to wit, this 8th day of April, 1946, rehearing in the above entitled case having been granted by the court en banc the 5th day of March 1946, It Is Hereby Ordered and

Directed that the opinion filed as of January 8, 1946, be and the same is hereby withdrawn.

By the Court, Jno. J. O'Connell, Circuit Judge.

Endorsements: Order Withdrawing Opinion. Filed Jan. 8, 1946. Received & Filed Apr. 8, 1946. Wm. P. Rowland, Clerk.

[fol. 131] UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1945

No. 8947

J. ROBERT BAZLEY, Petitioner;

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appeal from the Decision of the Tax Court of the United States

Argued November 20, 1945

Reargued March 5, 1946

Before Biggs, Maris, Goodrich, McLaughlin and O'Connell, Circuit Judges

OPINION OF THE COURT—Filed April 16, 1946

By O'CONNELL, Circuit Judge:

This is a petition to review the decision of the Tax Court sustaining an income tax deficiency assessed against J. Robert Bazley.[1]

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[1] The Tax Court upheld the Commissioner in assessing deficiencies against both J. Robert Bazley and Alice H. Bazley. By stipulation approved this judgment is controlling in the case of Alice H. Bazley. This case was originally argued before Biggs, McLaughlin and O'Connell, Circuit Judges. An opinion of the court, per O'Connell, Circuit Judge, was filed on January 8, 1946. Petition for reargument was granted. Reargument was had before the court en banc. Opinion of January 8, 1946, has been withdrawn and this supersedes it.

[fol. 132] Mr. and Mrs. J. Robert Bazley owned all but one share of J. Robert Bazley, Inc. As of February 1, 1939, the corporation had accumulated an earned surplus of $853,783.82. On March 16, 1939, the corporation distributed to Mr. and Mrs. Bazley and the one qualifying shareholder, in amounts proportionate to their shareholdings, $400,000 in twenty year debenture bonds.[2] A corresponding reduction in earned surplus was made on the books of the corporation. Is this $400,000 in twenty year debenture bonds, callable at the option of the obligor, freely marketable and admittedly worth their face value, taxable as ordinary income to the distributees? The Commissioner assessed a deficiency against the Bazleys for the year 1939 on the ground that the $400,000 in bonds represented taxable income in the hands of the recipients. The Tax Court upheld the Commissioner, concluding that the distribution of the bonds "was essentially equivalent to the declaration of a taxable dividend." Internal Revenue Code, Section 115 (g).[3] We are asked to reverse the Tax Court, chiefly on the assertion that the $400,000 in bonds are exempt from taxation because they were distributed in pursuance of a plan of reorganization of J. Robert Bazley, Inc., within the meaning of Section 112 of the Code.

Shortly prior to February 1, 1939, J. Robert Bazley, Inc., was engaged in general heavy contracting business with most of its operations consisting of coal mining by the open pit method. As previously indicated, the corporation's stock was owned by J. Robert Bazley, Alice H. Bazley, his wife, and Alfred Day, all of whom constituted the board [fol. 133] of directors. On February 16, 1939, these three people as owners of the outstanding capital stock of the corporation held a special meeting pursuant to resolutions adopted by themselves as the board of directors on February 6, 1939, and formally approved a proposed plan of reorganization. Resolutions authorizing the necessary corporate action for consummation of this plan were passed. On March 6, 1939, the Commonwealth of Pennsylvania ap-

[2] J. Robert Bazley received $319,200 in debenture bonds, Alice H. Bazley, his wife, received $80,400 in debenture bonds, and Alfred Day received $400 in debenture bonds.

[3] 26 U. S. C. (1940 ed.) Sec. 115 (g); 26 U. S. C. A. Sec. 115 (g).

proved the amendments to the company's Articles of Incorporation increasing the authorized common stock.

The reorganization is reflected in the table set forth below which indicates stock ownership and capitalization of the corporation before and after the occurrence of the transaction under scrutiny here.

Name	OLD Number of Shares	NEW Number of Shares	NEW Debenture Principal Amount
J. Robert Bazley	798	3,990	$319,200.00
Alice H. Bazley	201	1,005	80,400.00
Alfred Day	1	5	400.00
Total	1,000	5,000	$400,000.00

CAPITAL STRUCTURE OF CORPORATION

February 1, 1939 (Before proposed reorganization)	
1,000 shares common stock par value of $100 per share	$100,000.00
Earned Surplus	855,783.82
	$955,783.82
March 16, 1939 (After reorganization)	
Outstanding Debenture Bonds	$400,000.00
[fol. 134] 5,000 shares common stock without nominal or par value, the stated capital applicable to which is	300,000.00
Earned Surplus	255,783.82
	$955,783.82

On March 16, 1939, the stockholders delivered their 1,000 shares of old common stock to the corporation and received from the corporation the 5,000 shares of the new common stock[4] and debenture bonds in the aggregate prin-

[4] No attempt was made to tax receipt of the common stock, in whole or in part. *Cf. Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

cipal amount of $400,000. The old common stock was cancelled by the corporation.

Whether a corporation has cancelled its stock at such time and in such manner as to make the distribution and cancellation in whole or in part essentially equivalent to the distribution of a taxable dividend is a question of fact: Brown v. Commissioner, 79 F. 2d 73 (C. C. A. 3, 1935); Commissioner v. Champion, 78 F. 2d 513 (C. C. A. 6, 1935); Commissioner v. Babson, 70 F. 2d 304 (C. C. A. 7, 1934); Randolph v. Commissioner, 76 F. 2d 472 (C. C. A. 8, 1935); Hirsch v. Commissioner, 124 F. 2d 24 (C. C. A. 9, 1941). Consequently, we are powerless to disturb the Tax Court's determination of such a factual question if substantial evidence to support it exists: Helvering v. Kehoe, 309 U. S. 277 (1940). Nor will we controvert the Tax Court's holding by "treating as questions of law what really are disputes over accounting": Dobson v. Commissioner, 320 U. S. 489, 499 (1943). Indeed, such determinations seem to fall clearly within the *Dobson* rule: *Cf.* The John Kelley Co. v. Commissioner; Talbot Mills v. Commissioner, U. S. Sup. Ct., January 7, 1946.

In any event, as we view the record in this case, we believe the Tax Court, applying the correct criterion, reached the correct conclusion. Actually, no "sole decisive" [fol. 135] test for the application of Section 115 (g)[5] has been laid down: Flanagan v. Helvering, 116 F. 2d 937 (App. D. C. 1940), per Vinson, J. The history of Section 115(g), beginning with the Act of 1926, throws some light on the desired objective of Congress in passing such legislation In the House, Senate and Conference Reports[6] an illustration of the type of situation intended to be covered by this section was given thus: Suppose "* * * the case of two

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[5] 26 U. S. C. (1940 ed.) Sec. 115(g); 26 U. S. C. A. Sec. 115(g).

[6] H. Rep. No. 1, 69th Cong., 1st Sess. p. 5; S. Rep. No. 52, 69th Cong., 1st Sess. p. 15; H. Conference Rep. No 356, 69th Cong., 1st Sess. p. 30.

As pointed out in fn. 3 of Flanagan v. Helvering, *supra*, the illustration was made in connection with the Act of 1926, Sec. 201(g), 44 Stat. 11, 26 U. S. C. A., Int. Rev. Acts, p. 147. In relevant portion this is identical with the corresponding section of the 1939 Revenue Act, 26 U. S. C. (1940 ed.) Sec. 115(g).

men holding practically the entire stock of a corporation for which each paid $50,000. The corporation having accumulated a surplus of $50,000 above its cash capital, buys from the stockholders for cash one-half the stock held by them and cancels it, and the payment is non-taxable because it is a partial redemption of stock. To change this result and make it taxable [§ 115](g) was written and incorporated into the law."[7]

We see no real distinction between a case where the corporation pays cash for its outstanding stock and where the corporation pays in the form of debenture bonds for its old stock: see Doerschuck v. United States, 274 Fed. 739 (E. D. N. Y., 1921). In each case the application of Section 115(g) to the transaction under scrutiny depends on the particular facts: McGuire v. Commissioner, 84 F. 2d 431 (C. C. A 7, 1936); certiorari denied, 299 U. S. 591 (1936).

Under Section 115 (a)[8] a distribution out of accumulated earnings and profits is a "dividend." "Recapitaliza-[fol. 136] tion does not alter the 'effect' ": Commissioner v. Estate of Bedford, 325 U. S. 283, 292 (1945). The net worth of the corporation, i.e., the value of the stock in the hands of the stockholders, prior to the reorganization, was $955,783.82. This value, after reorganization, was $555,783.82. Clearly, the corporation has thus distributed $400,000 out of accumulated earnings and profits. The

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[7] For an example of the applicability of the illustration to an actual case, see Hyman v. Helvering, 71 F. 2d 342 (App. D. C., 1934); certiorari denied, 293 U. S. 570 (1934).

[8] 26 U. S. C. (1940 ed.) Sec. 115(a); 26 U. S. C. A. Sec. 115(a):

"(a). Definition of Dividend.—The term 'dividend' when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913; or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

face and market value of the bonds is admittedly $400,000. By their distribution to the stockholders, the corporation effectively consumed that much of the earned surplus which would otherwise be available for declaration of subsequent dividends. The Bazleys admit this.

To issue bonds, it would not have been necessary to adjust the value of the capital stock ($100,000) on the books of the corporation. Normally, the bonds would have been sold for cash, in which event no charge would have been made against earnings. But had the normal procedure been followed, to transfer the cash into the hands of the stockholders would necessitate a declaration of a dividend with the obvious consequent tax to the recipient. Such dividend would be a charge against earnings. Consider what was accomplished here. The same results were obtained. Instead of the stockholders paying cash into the treasury of the corporation and subsequently receiving an equivalent amount back, the bonds were distributed directly to the stockholders on the same basis as if declared as a dividend. But to accomplish the actual transfer of the bonds to the stockholders without technically declaring a dividend, the plan of cancelling the old stock was adopted. This distribution by the corporation of other property (the [fol. 137] bonds) out of its earnings and accumulated profits as a result of the cancellation of its old stock thus occurred at such time and in such manner as to make the distribution and cancellation essentially equivalent to the distribution of a taxable dividend.

In connection with the application of Section 115(g) to this transaction, we need not inquire into motive. The "basic criterion" is the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation: Smith v. United States, 121 F. 2d 692 (C. C. A. 3, 1941). Here, as pointed out above, the net effect of the distribution of the debenture bonds was to distribute to the petitioner a substantial segment of the previous earnings of the corporation: *Cf.* Commissioner v. Estate of Bedford, *supra*.[3]

[3] In the *Bedford* case, there was a *bona fide* "recapitalization-reorganization" which was effective to make tax-free the receipt of stock by the taxpayer under 26 U. S. C. (1940 ed.), Sec. 112(b)(3), Sec 112(c)(1), 26 U. S. C. A. Sec. 112 (b)(3), Sec. 112 (c)(1). Obviously this case is a much

The Tax Court's factual conclusion that this was a distribution out of earnings and profits, essentially equivalent to the distribution of a taxable dividend, disposes of the petitioner's contention that at the most he is taxable only at the capital gains rate. Sections 117, 112(b)(2) and [fol. 138] 112(c)(1).[10] These sections must be read and applied in conjunction with Section 115[11] which governs distributions and defines "dividend" as "any distribution made by a corporation to its shareholders, whether in money or other property * * * out of its earnings or profits accumulated after February 28, 1913, or * * * out of the earnings or profits of the taxable year * * *." Section 112 may not be used as a device for evading taxes Congress intended to impose. Commissioner v. Fisher, U. S. Sup. Ct., March 11, 1946.

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stronger one for imposing a tax than the "seemingly similar situation" where two corporations are involved and where the net effect is to transfer earnings of one corporation to another and then to distribute out of the second corporation's assets. In that type of case, "Where one corporation acquired the assets of another corporation in a tax free reorganization it is well settled that the earned surplus of the transferor becomes earned surplus of the transferee and is subject to taxation as a dividend on subsequent distribution to the stockholders of the transferee": Putnam v. United States, 149 F. 2d 721, 726 (C. C. A. 1, 1945), applying the doctrine of Commissioner v. Sansome, 60 F. 2d 931 (C. C. A. 2, 1932), certiorari denied 287 U. S. 667 (1932), which we followed in Corrigan v. Commissioner, 103 F. 2d 1010 (C. C. A. 3, 1939), certiorari denied 308 U. S. 576 (1939). For other cases in the long time following the *Sansome* decision, see f.n. 5 to Putnam v. United States, *supra* at p. 726.

Furthermore, in determining whether there has been a "distribution of a taxable dividend," it is immaterial whether the distribution occurs after an exchange of stock and assets of two corporations as in Commissioner v. Sansome, *supra*, or whether the assets of one corporation only are invoved: See Commissioner v. Estate of Bedford, *supra* at p. 291.

[10] 26 U. S. C. (1940 ed.) Sec. 117, 112(b)(2) and 412(c)(1); 26 U. S. C. A. Sec. 117, 112(b)(2) and 112(c)(1).

[11] 26 U. S. C. (1940 ed.) Sec. 115; 26 U. S. C. A. Sec. 115.

But, it is argued on behalf of the taxpayer that no tax whatsoever may be imposed on the $400,000 in bonds because they were received pursuant to a plan of reorganization of J. Robert Bazley, Inc. Admittedly, there was a "recapitalization" of J. Robert Bazley, Inc., in the corporate accounting sense. That, however, would not result in a tax exemption. It takes more than a mere literal matching of corporate actions with the words of Section 112 to qualify for tax freedom under the reorganization provisions of the Code: see Commissioner v. Gilmore's Estate, 130 F. 2d 791, 794 (C. C. A. 3, 1942). Reference to legislative history reveals that ten years' experience with the exchange and reorganization provisions of the Code led to a strong Congressional movement to excise them completely from the Revenue Act of 1934. They were retained in substantially their present form in reliance upon the prior practice of the courts to "interpret" their provisions so as to prevent escape from taxation in situations where Congress meant to grant no such exemption.[12] In the view of the then

[12] During the debate on the 1934 Revenue Act, the entire question of the retention of the reorganization sections of the Act was under serious consideration. On December 4, 1933, a subcommittee of the House Ways and Means Committee proposed the abolition of the exchange and reorganization provisions of Section 112. This was rejected. In its final form, the Revenue Act of 1934 contained what are substantially the same provisions of the present Act.

In the Report accompanying the submission of the Revenue Act of 1934 (H. R. No. 704, 73d Cong., Second Session), Chairman Doughton of the Committee stated, "The reorganization provisions have been in effect for many years, having been adopted in substantially their present form in 1924. They state in detail how each step of a reorganization should be treated for tax purposes. The policy was adopted of permitting reorganizations to take a wide variety of forms, without income-tax liability. As a result, astute lawyers frequently attempted, especially during the prosperous years, to take advantage of these provisions by arranging in the technical form of a reorganization, within the statutory definition, what were really sales. A number of these cases have been carried to the courts, with results on the whole favorable to the Government. The courts have shown a commendable tendency to look through the mere form of the transaction into its substance."

[fol. 139] Chairman of the House Ways and Means Committee, the reorganization sections were retained in the Code so that "legitimate reorganizations, required in order to strengthen the financial condition of the corporation will be permitted."[13] Since 1934, administrative interpretation of the reorganization section has limited its benefits to readjustments "as are required by business exigencies" and which are "undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."[14] Added sanction is given to the administrative interpretation by the re-enactment of the statute without disapproval of the regulations thereunder: United States v. Dakota-Montana Oil Co., 288 U. S. 459, 466 (1933); Helvering v. Winmill, 305 U. S. 79, 83 (1938); Helvering v. Griffiths, 318 U. S. 371, 395, 396 (1943); Commissioner v. [redacted]eler, 324 U. S. 542, 547, f.n. 10 (1945).

The Tax Court found nothing in the calling in of old common stock, issuance and distribution of new common stock, issuance and distribution of $400,000 in bonds which was required to strengthen the financial condition of the corporation. In considering the readjustments brought [fol. 140] about by the so-called reorganization, it did not conclude that this one was required by business exigencies or was undertaken for reasons germane to the continuance of J. Robert Bazley, Inc. It did find that, "There was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds." To be sure, the Bazleys advanced a number of reasons which, they said, motivated the financial transaction as a result of which they obtained the bonds.[15] None of these in which the Tax

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[13] See Report of Chairman Doughton of the House Ways and Means Committee, *supra*, f.n. 12.

[14] Treasury Regulations 86, under Revenue Act of 1934, Arts. 112 (g) 1-2. These have remained unchanged with the passage of succeeding revenue acts.

[15] They claimed the following reasons motivated the "reorganization": (1) the stockholders, by obtaining debenture bonds for their stock, would receive a more readily marketable and less fluctuating security in case it would become necessary for the estate of a deceased shareholder to liquidate his investment to meet inheritance taxes or for

Court put credence, however, were even remotely required by "business exigencies" or were "germane to the continuance" of J. Robert Bazley, Inc. To reverse the Tax Court in this case, we would have to hold the Treasury Regulations invalid. There is nothing unreasonable about the regulation. It is a valid exercise of the rule making power. Commissioner v. Wheeler, *supra*.

Indeed, even prior to the 1934 Act and the Regulations thereunder, the Second Circuit demonstrated that literal [fol. 141] compliance with the reorganization sections of the Code is insufficient to qualify for freedom from taxation if a particular situation would otherwise have called for a tax: Helvering v. Gregory, 69 F. 2d 809 (C. C. A. 2, March 19, 1934), interpreting Section 112 of the Revenue Act of 1928. Judge Learned Hand there considered the actions taken by the corporation and the shareholders in effecting a literal reorganization by forming a new corporation to which certain property was transferred and ultimately dis-

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other purposes; (2) the bonds could be sold without reducing the Bazley family's stock control of the corporation; (3) the contemplated entry into the hazardous business of road construction made it desirable for stockholders to possess bonds in order to be in a position at least equal to general creditors in the event of insolvency; (4) the value of the corporation's plant and equipment ($719,782.41 as of April 30, 1939) was large as compared with its capitalization of $100,000, and since such equipment had been purchased by using funds acquired through accumulation of $855,783.07 of earnings and profits, it was deemed advisable to reflect a dedication of these earnings to corporate use by reducing surplus available for dividends and transferring a part thereof to capital stock and a part to long-term debt represented by the 20-year bonds. Two additional motives advanced by the petitioner as reasons for the questioned transaction were (a) to provide stock of a type available for sale to the company's key employees and (b) to reduce the company's taxable income by $24,000 through the interest payments on the debenture bonds. The majority of the Tax Court refused to accept these two purposes as having existed in fact and, on the whole record, concluded that no legitimate corporate business purpose existed for the recapitalization.

tributed to the taxpayer. He remarked, at p. 811, "All these steps were real, and their only defect was that they were not what the statute means by a 'reorganization', because the transactions were no part of the conduct of the business of either or both companies; so viewed they were a sham, though all the proceedings had their usual effect." See Gregory v. Helvering, 293 U. S. 465, 469 (1935). So, too, in the present case, the Tax Court has found that there was in fact no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds. Considering actions and results, as we must in the doubtful realm of reorganizational exemptions,[16] we have already demonstrated that $400,000 was siphoned out of accumulated corporate earnings and distributed to the Bazleys and the lone qualifying shareholder in the form of debenture bonds. Congress obviously did not intend to grant a tax exemption in such a situation merely because, *qua* corporate accounting, there was a "recapitalization" and thus a "reorganization": *cf.* Commissioner v. Wheeler, *supra.* Clearly, a reversal of the Tax Court's holding would permit the use of the Section 112 exemption as a device for evading taxes Congress intended to impose under Section 115: *cf.* Commissioner v. Fisher, *supra.* In its last analysis, the [fol. 142] "recapitalization-reorganization" here under consideration accomplished nothing other than a distribution to the Bazleys and Day which consumed a large portion of the corporation's earned surplus otherwise available for the subsequent declaration of dividends. This result was one which, whatever the motives of the Bazleys may have been, cannot have the effect desired by the recipients of freedom from tax liability. For tax purposes, it stands as any other distribution under Section 115. The distributees must therefore pay income taxes on the bonds received to the extent of their face value.

Affirmed.

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[16] One claiming an exemption from a tax has the burden of sustaining his claim and the tendency is to disallow the claim where doubts are nicely balanced: see Trotter v. Tennessee, 290 U. S. 354, 356 (1933); *cf.* Lloyd v. Commissioner, C. C. A. 3, March 4, 1946.

MARIS and GOODRICH, *Circuit Judges*, dissenting:

The critical question in this case is, we think, one of law and one upon which this Court has an obligation to exercise its own judgment when the decision of the Tax Court is brought here for review. That question is whether a corporate reorganization, in order to be tax free, must be one conducted for a "corporate business purpose" of the corporation as distinguished from serving a proper business interest of the shareholders.

That this question is squarely presented there can be no doubt. The Tax Court's findings of fact with regard to the reasons for the transaction here in question are as follows:

> "Reasons for adopting the transaction hereinafter described involving the issuance of additional common stock and of debenture bonds were that the original shareholders, by obtaining debenture bonds for their stockholdings, would receive a security which was much less fluctuating and more readily marketable, particularly in case it was necessary for a deceased shareholder's estate to liquidate his investment in the corporation in order to meet inheritance taxes or for [fol. 143] other purposes, and that if it became necessary to sell some portion of their investment in the corporation the debenture bonds could be sold without reducing the Bazley family stock control of the corporation; that the contemplated entry into the hazardous road building business make it desirable to put the original stockholders in possession of bonds which would place them in a position of sharing alike with creditors to the extent of the debentures instead of ranking after creditors if the business did not succeed; that as of February, 1939, the corporation had plant and equipment of a value ($719,782.41 as of April 30, 1939), which was large in relation to the $100,000 par value of the capital stock outstanding, and since the equipment had been purchased by the use of funds acquired through the accumulation of $855,783.07 of earnings and profits since the organization of the business in 1930, it was thought advisable to reflect a more permanent dedication to corporate use of these earnings by reducing the surplus available for dividends and transferring a portion thereof to the capital stock

account and another portion to the long-term debt represented by 20-year debenture bonds."

An additional finding of fact is made as to the relation of the purpose and the corporate business. It reads as follows:

"There was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds."

The significance of these findings of fact is pointed up by the discussion of the Tax Court when it says:

"Such objectives as to create a security more desirable for the stockholders as being less fluctuating in value, more regular and certain in its income, easier to market for inheritance tax payments and furnishing greater safety against claims of corporate creditors are easily understandable from the standpoint of the stockholders. They furnish persuasive reasons [fol. 144] why the stockholders wanted to change the form of their investment. But, as we have said, a desire to encompass such an exchange without occasioning the tax consequences usually attendant upon those transactions would not supply the necessary purpose as a business or corporate object."

We accept the Tax Court's findings of fact. We also, now that we understand we are so to do, accept its conclusion when it applies its facts to a correct rule of law regardless of whether we, in a particular instance, would have reached the same conclusion or not. But if we believe the legal criterion used by the Tax Court is incorrect it is our duty so to say and to send the case back for appropriate proceedings under the application of what we deem the correct criterion.

We think that the criterion here making a distinction between "corporate" and "shareholder" purpose is incorrect. The foundation for it is supposed to be Gregory v. Helvering, 293 U. S. 465 (1935). That case involved the formation of a dummy corporation which did no business otherwise than to participate in a transfer which the taxpayer was seeking to effect without tax liability. What we

had was a sale masquerading as a reorganization. The court struck through the sham.

To expand that decision into a rule of law such as is now contended for is to push it beyond anything which we think the court could have had in mind. Nor do we think the expansion is one which a reasonable growth beyond Gregory v. Helvering would call for. We have long since passed the place in our thinking where we view the corporation as "an artificial being, invisible, intangible and existing only in contemplation of law". We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders. Shareholders, of course, may have conflicting interests among themselves with regard to the conduct of their common enterprise. They may fight with [fol. 145] each other, perhaps, in order to elect A instead of B to the directorship of their company. And, of course, aside from their interest in the common enterprise, called their corporation, they have interests as varied as the hopes and desires of human beings. But when we talk about the interest of shareholders in connection with the business enterprise and have a finding of fact that such and such a thing was done and that it was to the shareholders' business advantage, speaking of them as a group, we do not find substance in a distinction between the business advantages of the shareholders with respect to the corporation or the business advantages of the corporation itself.

Furthermore, this very thing concerned with here, reorganization, is a matter in which shareholders directly participate. The day to day business of the corporation is done by its officers, directors, employees. But a realignment of the interests in the enterprise through reorganization must come, under every corporation law we know of, through vote of the shareholders. In such circumstances it is as a practical matter impossible to separate as to the very transaction involved, a "shareholder's" from a "corporate" interest.

We think the distinction attempted coming, as it does, quite a number of years after Gregory v. Helvering, is one not established by that decision, the statute, nor the regulations. If reorganization provisions contain too many avenues of escape for taxes which ought to be collected the Congress can close those avenues by appropriate legislation

which can be so framed and defined as to leave the way clear to what it deems are business transactions in which no gain or loss should be recognized. We do not think it should be by judicial decision which establishes the exceedingly vague criterion as to whether a given transaction was to the interest of the shareholder as distinguished from the interest of the corporation in which he holds shares of stock.

[fol. 146] The gloss here sought to be placed upon those provisions of Section 112 of the Internal Revenue Code which render non-taxable the exchange of certain securities in connection with corporate reorganizations, can only be justified upon the assumption that all reorganizations which are put through by stockholders solely to promote their own business purposes must necessarily involve the motive of tax avoidance. Only upon this assumption can the principle of Gregory v. Helvering be applicable. But this assumption is quite unsound as the facts of the case before us demonstrate. And even clearer cases can readily be brought to mind. Suppose a case in which the common shareholders arrange for the reclassification of a part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control. This would be a perfectly proper business purpose of the stockholders involving not a trace of tax avoidance but it would not benefit the business of the corporation as such. We do not think that there is any authority for the proposition that such a recapitalization would not be within both the letter and the spirit of Section 112.

A true Copy: Teste:

——, Clerk of the United States Circuit Court of Appeals for the Third Circuit.

[fol. 147] IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, OCTOBER TERM, 1945

No. 8947

J. ROBERT BAZLEY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Present: Biggs, Maris, Goodrich, McLaughlin and O'Connell, Circuit Judges.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

By the Court, John J. O'Connell, Circuit Judge.

April 16, 1946.

Endorsements: Order Affirming Decision of Tax Court. Received & Filed April 16, 1946. Wm. P. Rowland, Clerk.

[fol. 148] UNITED STATES OF AMERICA,
Eastern District of Pennsylvania,
Third Judicial Circuit, Set.:

I, Wm. P. Rowland, Clerk of the United States Circuit Court of Appeals for the Third Circuit, do hereby certify the foregoing to be a true and faithful copy of the original Appendix to Brief for Petitioner, as constituting the portions of the record before this court at argument; and proceedings in this court, in the case of J. Robert Bazley, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 8947, on file, and now remaining among the records of the said Court, in my office.

In Testimony Whereof, I have hereunto subscribed my name and affixed the seal of the said Court, at Philadelphia,

this 26th day of June in the year of our Lord one thousand nine hundred and forty-six, and of the Independence of the United States the one hundred and seventieth.

Wm. P. Rowland, Clerk of the U. S. Circuit Court of Appeals, Third Circuit. (Seal.)

[fol. 149] Supreme Court of the United States, October Term, 1946

No. 287

Order Allowing Certiorari—Filed October 14, 1946

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted, and the case is assigned for argument immediately following No. 209, Adams vs. Commissioner.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

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JUL 11 1946
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

No. 287

October Term, 1946.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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INDEX OF PETITION AND BRIEF.

	Page
Petition for Writ of Certiorari	1
Statement of the matter involved	1
Jurisdiction	4
Questions presented	5
Reasons for allowance of the Writ	5
Brief	11
Opinions below	11
Jurisdiction	11
Statement of the case	11
Specification of Errors	11
Statutes involved	12
Argument	13
Addendum	23
Internal Revenue Code:	
Section 112 (a)	23
Section 112 (b) (2)	23
Section 112 (b) (3)	23
Section 112 (c) (1)	24
Section 112 (c) (2)	24
Section 112 (g) (1) (E)	23
Section 115 (a)	24
Section 115 (c)	25
Section 115 (g)	25
Section 117 (b)	25
Regulations 103, Sec. 19.112 (g)-2	23

TABLE OF CASES CITED.

	Page
Adams v. Commissioner (CCA 3rd), unreported, Docket No. 9069, October Term 1945, petition for certiorari filed	7
Adams, Adam A., 4 TC 1186, 5 TC 351	16
Annis Furs, Inc., 2 TC 1096	15
Bailey, Est. of Walter C., 37 BTA 647	15
Bass, Edith B., 45 BTA 1117, 129 F (2d) 300 (CCA 1st)	19
Capento Securities Corp., Commissioner v., 140 F (2d) 382 (CCA 1st)	14
Cogan, Philip J., 36 BTA 639	15
Claude Neon Lights, Inc., 35 BTA 424	15
Dobson v. Commissioner, 320 U. S. 489	4, 8, 19, 22
Docherty, Edgar M., 47 BTA 462	15
Electrical Securities Corp. v. Commissioner, 92 F (2d) 593 (CCA 2nd)	14
Electrical Securities Corp., 34 BTA 988	15
Fischer, Jacob, 46 BTA 999	15
Flanagan v. Helvering, 116 F (2d) 937 (CCA, DC)	19
Flanders Investment Co., 33 BTA 483	15
Franklin, Harold B., 34 BTA 927	15
General Motors Corp., 35 BTA 523	15
Gilmore's Estate, Commissioner v., 130 F (2d) 791 (CCA 3rd)	14
Graham, George D., 37 BTA 623	15
Gregory v. Helvering, 293 U. S. 465,	3, 5, 6, 7, 12, 13, 14, 15, 16, 18
Griffiths v. Commissioner, 308 U. S. 355	14
Handbird Holding Corp., 32 BTA 238	15
Hartzel, Elmer W., 40 BTA 492	15
Heady, Marion, Tax Court Docket No. 5812, unreported, but see CCH TC Service, Dec. No. 14,702 (M)	7, 16
Humko Co., Tax Court Docket No. 112235, 79, unreported, but see CCH TC Service, Dec. 13,642 (M)	16

TABLE OF CASES CITED (Continued).

	Page
Johnson, James Lee, 37 BTA 155	15
Kleeman, Arthur S., 35 BTA 17	15
Knapp Monarch Co. v. Commissioner, 139 F (2d) 863 (CCA 8th)	15
Kolb, Commissioner v., 100 F (2d) 920	7, 15
L. and E. Stirn, Inc., 39 BTA 143	15
Lea, Helen Sperry, 35 BTA 243	15
Loewenberg, Belle G., 39 BTA 844	15
Lyon v. Commissioner, 127 F (2d) 210 (CCA 6th)	14
McCormick, Robert R., Exec., 33 BTA 1046	15
Mellon, A. W., 36 BTA 977	15
Minnesota Tea Co., Helvering v., 296 U. S. 378	14
Morainville v. Commissioner, 135 F (2d) 201 (CCA 6th)	15
Morgan Mfg. Co. v. Commissioner, 124 F (2d) 602 (CCA 4th)	14
Morgan, Robert M., 41 BTA 379	15
National Investors Corp. v. Hoey, 144 F (2d) 466 (CCA 2d)	14
Peck and Peck, 42 BTA 651	15
Perkins, Thomas N., 33 BTA 606	15
Pickard, Sam, 40 BTA 258	15
Royal Marcher, 32 BTA 76	15
Schoo, Clarence J., 47 BTA 459	15
Skenandoa Rayon Corp. v. Commissioner, 122 F (2d) 268 (CCA 2nd)	15
Smith, Commissioner v., 136 F (2d) 556 (CCA 2d)	14
Souther, Chester A., 39 BTA 197	15
Tyson, Commissioner v., 146 F (2d) 50 (CCA 8th)	14
Von's Investment Co., Ltd., 33 BTA 30	15
Watts, Helvering v., 296 U. S. 387	13
W. and K. Holding Corp., 38 BTA 830	15

STATUTES CITED.

Page

Internal Revenue Code—53 Stat. (Part 1): 26 U. S. C. A.:—

Section 112, 53 Stat. 37 ..... 12, 13, 17, 23
Section 112 (b), 53 Stat. 37 6
Section 112 (b) (2), 53 Stat. 37 ..... 5, 23
Section 112 (b) (3), 53 Stat. 37 ..... 3, 5, 6, 12, 16, 20, 23
Section 112 (c) (1), 53 Stat. 39 ..... 5, 24
Section 112 (g) (as amended 1939), 53 Stat. 870 ..... 5, 12, 16, 20
Section 112 (g) (1) (E) (as amended 1939), 53 Stat. 870 3
Section 115 (g), 53 Stat. 48 ..... 5, 25
Section 117, 53 Stat. 50 ..... 4, 5, 12, 19, 25
Section 1141, 53 Stat. 164 5

Judicial Code—48 Stat. 938; Sec. 240 (a) (U. S. C. A., Title 28, Sec. 347) 4

TREASURY REGULATIONS CITED.

Page

Reg. 103, Sec. 19.112 (g)-2 ..... 7, 23, 24

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1946.

No.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, J. Robert Bazley, prays that a writ of certiorari issue to the United States Circuit Court of Appeals for the Third Circuit, which affirmed the decision of the Tax Court sustaining the respondent in holding petitioner liable for additional Federal income tax for 1939, in the sum of $214,170.52, by reason of his exchange, pursuant to a Plan of Reorganization, of his 798 $100 par shares of the common stock of J. Robert Bazley, Inc., held by him since 1930, for 3,990 no par shares and $319,200 principal amount of 20 year 6% debenture bonds of said corporation.

Statement of the Matter Involved.

In 1939 petitioner's company, of which he and his wife owned practically all the outstanding stock (1,000 $100 par shares) was engaged in the contracting business, principally in "stripping" the earth and rock overlying veins of an-

thracite coal. This business being then very poor, petitioner's Company considered going into the hazardous business of road building. The Company having accumulated a surplus of $855,783.82, most of which had been ploughed back into plant and equipment, it was deemed advisable to rearrange the company's capital structure so that less would be represented by the stock, both in order to leave less at the risk of the business and in order to reduce the unit value of the shares. Accordingly, a recapitalization was duly effected under Pennsylvania law, the outstanding 1,000 shares of $100 par stock being exchanged for 5,000 no par shares and $400,000 principal amount of 20 year 6% debenture bonds.

The Tax Court found four "reasons for adopting the transaction" (R. pp. 91a-92a):—

1. The stockholders, in receiving in exchange for the outstanding 1,000 shares, debentures as well as no par stock, would have, in part, a more marketable security, which would be particularly advantageous where necessary to liquidate a part of a deceased stockholder's investment in order to meet inheritance taxes and other expenses.

2. The debentures could be sold by the stockholder where necessary without reducing the stock control in the management of the company.

3. The debentures would constitute a preferred obligation which, in case of eventual reverses incident to the hazardous road building in which the company was embarking, would share with creditors.

4. By reason of the fact that a large part of the company's earnings had been reinvested in fixed assets, it was deemed proper that the part of the earned surplus represented by the increased stated value of the common stock and by the par value of the bonds should be transferred from earned surplus to capital, and no longer be available for dividends.

The Tax Court refused to credit petitioner's testimony that an additional reason was that petitioner and his associates deemed it desirable, by reducing the unit value of the stock, to make it feasible to sell some of it to the key employees and so give them a stake in the business,—because this had not in fact been done up to the time of the hearing. Petitioner, while pointing out that the company's capital structure had in fact been altered so as to make such a future sale feasible, does not, for the purpose of this appeal, dispute the Tax Court's finding.

The Tax Court held that the four reasons which it found had motivated the recapitalization were all reasons which benefited the *stockholders* as distinguished from the corporation. Construing this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465, a majority of the Tax Court held, (applying such construction for the first time in this case) that, although this was a transaction within the terms of section 112 (b) (3) [1] of the Act, and although the debentures were admittedly "securities" thereunder, nevertheless, in order for a recapitalization or other reorganization to come within such provisions it must have been undertaken for and result in a benefit to the *corporation* as distinguished from one to the *stockholders*. The majority of the Tax Court also refused to recognize any benefit to the corporation in the alteration of its capital structure in the manner which the stockholders desired, or in the saving of taxes by deducting the $24,000 annual interest charge on the debentures.

Five of the sixteen Judges of the Tax Court dissented.

The Circuit Court, Judges Maris and Goodrich dissenting, upheld the position of the majority of the Tax Court.

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(1) 112 (b) (3) "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

112 (g) "As used in this section . . . (1) The term 'reorganization' means . . . (E) a recapitalization."

The second point in the case was, assuming that the transaction did not constitute a tax-free reorganization because lacking a "corporate business purpose," nevertheless, since under the express allegations and admissions of the Commissioner and the express findings of the Tax Court it constituted a *single unitary transaction*,—the receipt of the new stock *and* debentures in exchange for the old stock, which had been held for 9 years,—any resulting gain was taxable as a *capital gain* under Section 117.

On this second point the Tax Court attempted no logical reconciliation of its *finding of fact* [2] that the transaction was a unitary exchange of old stock for new stock *and* debentures, with its *conclusion* that the distribution of the debentures was a taxable dividend. The Circuit Court in its original opinion (R. pp. 106-116), attempted to sustain the Tax Court's conclusion by revising the Tax Court's express finding that the transaction was a single exchange of old stock for new stock and bonds, so as to divide the transaction into two distinct steps,—an exchange of the old stock for new stock "followed by a distribution of the 20-year debenture bonds." The Court's attention having been called, on the reargument, to the Commissioner's express allegations and admissions that this was a single exchange and the Tax Court's finding to the same effect, the majority, in its revised opinion, ignored the Tax Court's finding to the effect that the exchange was a single transaction, and omitted the reference which it had made at the end of the first opinion to this Court's statement in the *Dobson* case [3] that "whether an apparently integrated transaction shall be broken up into several separate steps" is a question of fact on which the Tax Court's finding is controlling.

Jurisdiction.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of

(2) See *infra* Brief, pp. 19-22 hereof.
(3) *Dobson v. Commissioner*, 320 U. S. 489, 502.

February 13, 1925 (43 Stat. 938, U. S. C. Title 28, section 347) and Section 1141 (a) of the Internal Revenue Code.

The judgment of the United States Circuit Court of Appeals to be reviewed was entered on April 16th, 1946, (No. 8947 October Term, 1945).

Questions Presented.

1. Did the receipt by petitioner of debenture bonds (with new common stock) of J. Robert Bazley, Inc., pursuant to a Plan of Reorganization of that Corporation duly adopted, whereby the entire 1,000 shares of previously outstanding par stock (including petitioner's 798 shares) were exchanged for 5,000 new no par shares *and* $400,000 6% debenture bonds, give rise to a non-recognized gain, the taxation of which was postponed under Section 112 (b) (3) and 112 (g) of the Internal Revenue Code, or did it constitute a dividend taxable under Section 115 (g)?

2. Under *Gregory v. Helvering,* 293 U. S. 465, must it affirmatively appear, in order that such recapitalization come within Sections 112 (b) (3) and 112 (g), that it was adopted and carried out for the benefit of the *corporation* as distinguished from a benefit to *stockholders?*

3. Was the present Plan adopted and carried out pursuant to a "legitimate corporate business purpose"?

4. If the receipt of such debentures with such new common stock in the exchange for old common stock did *not* constitute such a recapitalization, was not the gain realized therefrom a gain from an exchange, taxable as capital gain under Sections 112 (b) (2), 112 (c) (1) and 117?

Reasons for Allowance of the Writ.

I. This case raises important questions of federal law which have not been, but should be, settled by this court.

By a novel construction of this Court's opinion in *Gregory v. Helvering,* 293 U. S. 465, applied for the first

time to a decision more than nine years thereafter, the Tax Court has read into Section 112 (b) (3) a requirement that in order to come thereunder, a recapitalization must be for a "corporate business purpose," constituting a benefit to the corporate entity as distinguished from a benefit to the shareholders. There is, as is pointed out in the following brief, no basis in this Court's opinion in the *Gregory* case or in any of this Court's later decisions, to support this doctrine, nor had it been applied by the Tax Court or by any other Court in any decision prior to that in the case at bar.

There could be, it is submitted, no case involving more clearly a question of law than one which turns on the Tax Court's construction of a prior decision by this Court.

The gloss which, nine years after the *Gregory* decision, the Tax Court has read into it, introduces an attempted distinction,—between the bona fide purposes of a corporation and those of its shareholders,—so vague and legally unsound as to inject serious and unjustified confusion into the administration of Section 112 (b) of the Revenue Act. In case of many proper recapitalizations, such as those mentioned at the end of the Circuit Court's dissenting opinion, it would be impossible to find a distinct corporate motive; in many others, both those already consummated and others in the future, it will be impossible to determine in advance whether such a motive will be recognized by the Commissioner and by the Courts.

II. The decision is in conflict with other decisions of the Circuit Courts and of the Tax Court and with the Treasury Regulations.

While, because the "corporate business purpose" test is a recent invention of the Tax Court, the precise question involved in the first point has not heretofore been directly discussed by any Court, several Federal decisions are irreconcilable with it, as are numerous decisions by the Tax Court, cited in the following brief.

Shortly after the first argument in the case at bar before Judges Biggs, McLaughlin and O'Connell, another case involving the identical question, *Adams v. Commissioner*,[4] was argued before Judges Maris, Goodrich and O'Connell of the same Court. Reargument was ordered with that in the case at bar prior to any decision thereon, but it would appear, from the dissents of Judges Maris and Goodrich in the case at bar, that a majority of that Court supported the position of the petitioner Adams and that if a formal decision had been reached there would have been two conflicting decisions in the same Circuit.

The decision sought to be reviewed is irreconcilable with that of the Ninth Circuit in *Commissioner v. Kolb*, 100 F. (2d) 920, where, on page 926, in answer to the contention that the transaction was a sham condemned by the *Gregory* case, the Court enumerates ten "business purposes" for the recapitalization there approved, several of which, including the issue of $2,000,000 bonds for stock, could have been of no benefit to the corporation as distinguished from the stockholders.

The identical question is pending in the Seventh Circuit in *Heady v. Commissioner*, to review the decision of the Tax Court in *Heady*,[5] in which petitioner's brief has been filed, but argument not yet heard.

The decision of the Court below is irreconcilable with Sec. 19.112 (g)-2 of the Treasury Regulations defining and affirming as a "recapitalization" a case where:

> "(3) a corporation issues preferred stock, previously authorized but unissued, for outstanding common stock."

in which obviously no independent corporate purpose or benefit could be deduced.

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(4) Unreported, Docket No. 9069, October Term, 1945, petition for certiorari filed.

(5) Tax Court Docket No. 5812, unreported, but see C. C. H. T. C. Service, Dec. 14702 (M).

III. The decision of the court below is in conflict with applicable decisions of this Court.

The Tax Court found, in accordance with the express allegations and admissions of the Commissioner, that the recapitalization was a single transaction consisting of an exchange of the 1,000 old shares of $100 par for 5,000 new no par shares and $400,000 debenture bonds. Despite this finding, the Tax Court concluded that the debentures constituted a dividend on the stock. In order to sustain the conclusion of the Tax Court, the Circuit Court, contrary to the finding of fact by the Tax Court, said that the debentures were distributed, not as a part of the exchange constituting the recapitalization, but "following" it.

Under the decision of this Court in *Dobson v. Commissioner*, 320 U. S. 489 and subsequent cases, it is not the function of the Circuit Courts to modify the primary findings of fact by the Tax Court in order to sustain its conclusions, any more than to reverse them.

Had the Circuit Court accepted the Tax Court's primary finding of fact, it necessarily follows that assuming this was not a tax free reorganization, any resulting gain from a receipt of the bonds should have been taxed as a capital gain under Section 117.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Court directed to the United States Circuit Court of Appeals for the Third Circuit, sitting at Philadelphia, Pennsylvania, commanding that Court to certify and to send to this Court, on a day certain to be therein named, a full and complete transcript of the record and all proceedings had in this case numbered and entitled on its docket [redacted], to the end that this case may be reviewed and determined by this Court; that the said judgment of the United States Circuit Court of Appeals for the Third Circuit may be reversed by this Court; and that your petitioner

may have such other and further relief in the premises as may seem just and proper.

And your petitioner will ever pray, etc.

J. Robert Bazley,
Petitioner.

Henry S. Drinker,
1429 Walnut Street,
Philadelphia 2, Pa.,
Attorney for Petitioner.

BRIEF IN SUPPORT OF THE PETITION.

Opinions Below.

The opinion of The Tax Court of the United States in this proceeding was promulgated on February 28, 1945. It is reported at 4 T. C. 897, and is printed on pages 89a-104a of the Record.

The opinions of the United States Circuit Court of Appeals for the Third Circuit have not been officially reported at the time of filing of this brief. The opinion of the three judges on the original argument was rendered on January 8, 1946, and is printed on pages 106-116 of the Record. This opinion was withdrawn by the Court on April 8, 1946 (R. pp. 125-126). The opinion of the majority (O'Connell, McLaughlin and Biggs, JJ.) of the five judges who heard the reargument was rendered on April 16, 1946, and is printed on pages 126-136 of the Record; and the dissenting opinion of Judges Maris and Goodrich upon the reargument is printed at pages 137-140 of the Record.

Jurisdiction.

The grounds on which jurisdiction of this Court is invoked are set forth in the Petition at pages 4-5 thereof.

Statement of the Case.

The Statement of the Case appears in the Petition at pages 1 to 4, and in the interest of brevity is not repeated here.

Specification of Errors.

The Circuit Court of Appeals erred:

1. In holding that a recapitalization, planned and duly consummated for bona fide purposes other than tax avoid-

ance, was not within the provisions of Sections 112 (b) (3) and 112 (g) of the Revenue Act because not undertaken for the benefit of the corporation as distinguished from that of the stockholders.

2. In supporting the Tax Court in its construction of this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465 as so stating the law.

3. In ignoring the Tax Court's finding of fact that the recapitalization under review consisted of a unitary exchange of old stock for new stock *and* debenture bonds, and holding that it consisted of an initial exchange of old stock for new stock *followed by* a distribution of the debentures, which constituted a taxable dividend, whereas, assuming that this was not a tax free "reorganization" under Section 112, the gain resulting was a capital gain, taxable under Section 117.

Statutes Involved.

The pertinent provisions of the Internal Revenue Code and of the Treasury Department Regulations are set forth at the end of this Brief.

ARGUMENT.

It is believed that the principal matter in the present petition requiring elaboration is the statement that the application and extension of the *Gregory* decision to disallow recapitalizations, not shown to have been for the benefit of the corporation, as distinguished from a benefit to all its stockholders, is a recent invention by the Tax Court, not warranted by this Court's opinion in that case.

This brief will therefore be devoted primarily to a concise history of the application of the *Gregory* decision in the Tax Court and the Circuit Courts, followed by brief comments on the basic legal unsoundness of the Tax Court's conclusion and the unfortunate consequences of introducing so vague and unworkable a test into the administration of Section 112 of the Revenue Code.

Gregory v. Helvering.

Both the Tax Court and the majority of the Court below recognize that the exchange of all the outstanding stock of a corporation for new stock *and* bonds constitutes a recapitalization and thus a reorganization under Section 112 of the Internal Revenue Code. *Helvering v. Watts,* 296 U. S. 387.

Gregory v. Helvering, 293 U. S. 465, did not hold that, in order to qualify as tax free, a "recapitalization" must be undertaken for the benefit of the *corporation* as distinguished from its *stockholders.* What it held was that where a dummy corporation is formed and used for the sole purpose of avoiding an impending tax liability, and is dissolved as soon as that purpose has been accomplished, it having in the meantime served no legitimate business purpose, it may be disregarded, and the transaction viewed in its true light, since the term "reorganization" does not contemplate a sham transaction adopted for the sole purpose of tax avoidance by means of a dummy corporation having no business function.

This Court did not, as the Tax Court and the majority of the Court below would apparently have it appear, speak of a "corporate business purpose." The Court merely referred to the dummy corporation as "an operation having no business or corporate purpose."

The idea that the *Gregory* case condemns a "recapitalization" (not undertaken or effective for the sole purpose of avoiding taxes), unless this be demonstrably for the benefit of the corporation, is an invention of the Tax Court and unsupported by any other court except the majority of the Court below. The fact that the change in capitalization is adopted by the stockholders for *reasons other than tax avoidance* renders the *Gregory* case inapplicable.

In none of the later decisions by this Court has the *Gregory* decision been interpreted or extended as the Tax Court and the Court below would have it appear. In all of them the decision was understood merely as prescribing the disregarding of sham corporations formed and used for the sole purpose of tax avoidance. See, for example, *Helvering v. Minnesota Tea Co.*, 296 U. S. 378, 385; *Griffiths v. Commissioner*, 308 U. S. 355, 357-358.

The interpretation of the case by the Circuits is to the same effect.[1]

Origin of the "Corporate Business Purpose" Test.

During the years following *Gregory v. Helvering*, that decision was applied by the Tax Court solely to cases

(1) See
Electrical Securities Corp. v. Commissioner, 92 F. (2d) 593, 594-595 (C. C. A. 2d);
Commissioner v. Gilmore's Estate, 130 F. (2d) 791, 795-796 (C. C. A. 3rd);
Commissioner v. Smith, 136 F. (2d) 556, 559 (C. C. A. 2d);
National Investors Corp. v. Hoey, 144 F. (2d) 466, 468 (C. C. A. 2d);
Morgan Mfg. Co. v. Commissioner, 124 F. (2d) 602, 605 (C. C. A. 4th);
Lyon v. Commissioner, 127 F. (2d) 210, 213 (C. C. A. 6th);
Commissioner v. Capento Securities Corp., 140 F. (2d) 382, 385 (C. C. A. 1st);
Tyson v. Commissioner, 146 F. (2d) 50, 54 (C. C. A. 8th).

similar to that there involved,—where the sole owner of the stock of a corporation desired to secure for sale to a prospective purchaser a portion of the corporation's assets, and for the purpose of avoiding the surtax which would result from receiving such assets as a dividend, organized a "conduit" corporation through which the asset should be passed and the dummy corporation be dissolved or become moribund, the transaction having been motivated solely by a desire to avoid an impending tax, the *conduit corporation* conducting no real business, and the whole transaction constituting what the Tax Court terms a "sham", masquerading in the guise of a reorganization.[2]

Where the Board considered that the transaction was a genuine one and not a sham, it held in these early cases that the *Gregory* principle was inapplicable.[3]

In a number of cases the Board of Tax Appeals and the Tax Court sustained recapitalizations which were clearly for the sole benefit of the stockholders, as distinguished from the independent corporate benefit, the distinction, later invented, not being discussed.[4]

Other recapitalizations which were not claimed to have benefited the corporation as distinguished from the stockholders, have similarly been sustained by the Circuit Courts.[5]

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(2) See *Royal Marchen*, 32 B. T. A. 76; *Handbird Holding Corp.*, 32 Id. 238; *Von's Investment Co., Ltd.*, 33 Id. 30; *Flanders Investment Co.*, 33 Id. 483; *Thomas N. Perkins*, 33 Id. 606; *Robt. R. McCormick, Exec.*, 33 Id. 1046; *Harold B. Franklin*, 34 Id. 927; *Electrical Securities Corp.*, 34 Id. 988; *Arthur S. Kleeman*, 35 Id. 17; *Helen Sperry Lea*, 35 Id. 243; *Philip J. Cogan*, 36 Id. 639; *A. W. Mellon*, 36 Id. 977; *George D. Graham*, 37 Id. 623; *Estate of Walter C. Bailey*, 37 Id. 647; *W. & K. Holding Corp.*, 38 Id. 830; *Belle G. Loewenberg*, 39 Id. 844; *Sam Pickard*, 40 Id. 258; *Robert M. Morgan*, 41 Id. 379.

(3) *Claude Neon Lights, Inc.*, 35 B. T. A. 424; *General Motors Corp.*, 35 Id. 523; *James Lee Johnson*, 37 Id. 155.

(4) *L. & E. Stirn, Inc.*, 39 B. T. A. 143; *Chester A. Souther*, 39 Id. 197; *Elmer W. Hartzel*, 40 Id. 492; *Peck and Peck*, 42 Id. 651; *Jacob Fischer*, 46 Id. 999; *Clarence J. Schoo*, 47 Id. 459; *Edgar M. Docherty*, 47 Id. 462; *Annis Furs, Inc.*, 2 T. C. 1096.

(5) See

Commissioner v. Kolb, 100 F. (2d) 920, 926 (9th Circuit);
Skenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268 (2d Circuit);
Morainville v. Commissioner, 135 F. (2d) 201 (6th Circuit);
Knapp Monarch Co. v. Commissioner, 139 F. (2d) 863 (8th Circuit).

The supposed necessity for a *corporate* business purpose as distinguished from a *stockholders'* objective, unrelated to tax avoidance, is a recent invention by the Tax Court, having been first definitely suggested in a dictum by Judge Harron in the case of *Humko Co.*,[6] decided by her in December, 1943, almost nine years after the *Gregory* decision. This test was applied by the Tax Court for the first time in the case at bar and in the companion case of *Adams*, 4 T. C. 1186; 5 T. C. 351 (*supra*, p. 7), and also in *Heady, supra*, now on appeal in the Seventh Circuit.

The Basic Unsoundness of the Tax Court's Test.

It is a fundamental principle of corporation law that all activities within the scope of the corporate charter,—whatever the corporation may properly do for its corporate benefit, in the furtherance of its business,—are to be carried on by its board of directors. Stockholder action is required and appropriate only in connection with matters which concern the relation of the stockholders among themselves,—which modify the agreement among them incident to their formation of the corporation, with which matters the corporation itself is not directly concerned. Thus, the directors alone may properly authorize the making of contracts. Under the laws of no State, however, may the directors change the capitalization by authorizing stock not provided for in the charter, or by altering the rights of the stockholders inter sese. These matters are for the *stockholders* and are a part of *their* business, not a part of the corporation's ordinary business.

The reorganization provisions of the Revenue Act are not confined to matters within the scope of the corporation's business,—matters which may be regulated by the directors; see Sec. 112 (b) (3), 112 (g) (1). These provisions apply to the stockholders as well as to the corporation. Indeed, the provisions relative to recapitalization

(6) Docket 112235, 79, unreported, but see C. C. H. T. C. Service, Dec. 13,642 (M).

concern the stockholders primarily, if not exclusively. Neither the Tax Court nor respondent nor the majority of the Court below have suggested any reason why, as to recapitalizations, a "business purpose" test should apply only to the corporation and should not apply to the stockholders, whose action as such is necessary to bring it about. Nor have they explained how there can conceivably be a "corporate business purpose" in connection with something which may be no part of the corporation's business and which, through its board of directors, charged with regulating its business, it has no power to regulate.

The Tax Court Has Invented a Test so Vague as to be Practically Unworkable.

The disregard by the majority of the Tax Court and by the majority of the Court below of the fundamental principle above summarized would, if followed, introduce into the administration of Section 112 of the Revenue Act a test so vague and variable as to introduce lamentable uncertainty into the administration of the law. As the dissenting opinion of Judges Maris and Goodrich clearly demonstrates, what is for the benefit of the corporation, as distinct from that of the stockholders, and vice versa, is something on which no two lawyers, no two accountants or no two business men could agree. To inject such a test as that proposed by the Tax Court into the administration of the law would render the soundness of a recapitalization under Section 112 dependent principally on the whim of the revenue agent, the Commissioner, or the Judge who passed on the case. It would also throw doubt on a great number of completed recapitalizations about which no previous doubt existed. For example, there have been and will doubtless be innumerable instances of reorganizations of corporations a majority of the entire capital stock of which is owned by a holding company which, for reasons of its own, desires to have the securities of a subsidiary in a different form,—stock for stock, bonds for stock, preferred

of a different type, etc. There has never been any suggestion that these recapitalizations are not tax free, although it is inconceivable that there could be any purpose except that of the holding company whose wishes the subsidiary is bound to carry out.

In the great majority of cases involving recapitalizations, the changes in the capitalization of a corporation are in reality advantageous only to the stockholders. For example, is there a demonstrable corporate advantage in the exchange of $100,000. par value 4% preferred stock and $100,000. par value of common stock for $80,000. par value 5% preferred and 1250 shares of no par common? What corporate advantage is there in the substitution of preferred stock for common stock, or in the recapitalization noted at the end of the dissenting opinion, where common stockholders arranged for a reclassification of part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control? If the rule here established be followed, it will set up a test of the validity of scores of recapitalizations so vague as to be wholly unpredictable, resulting in conclusions based on no substantial differences, in cases, all of which result in no change of continuity in control and in no present realization of actual gain to the stockholders, but merely in a change in the form of the security. Such a radical departure from long existing practice and legal standards should, it is submitted, be effected only by a prospective amendment to the law by Congress, or, at least, by this Court's own construction of its decision in *Gregory v. Helvering*.

The Dissenting Opinion.

The dissenting opinion by Judges Maris and Goodrich contains so clear and concise an analysis of the legal principles which these two judges apply to the Tax Court's findings of fact, that we find it impossible to summarize or abstract it. Accordingly, we refer to it, as printed on pages

137-140 of the Record, for a clear exposition of the fallacy of the Tax Court's "corporate business purpose" theory.

Findings of the Tax Court as to Unitary Exchange of Old Stock for New Stock *and* Bonds.

The second major ground on which this Court is asked to review the decision below is that the Circuit Court, contrary to the rule in *Dobson v. Commissioner*, 320 U. S. 489, has changed and modified an essential primary finding of fact by the Tax Court in order to sustain its conclusion of tax liability.

Assuming, for the purpose of the present argument, that the recapitalization was not tax free because not demonstrably for the benefit of the corporation, either

(1) the transaction was a single transaction,—a unitary exchange of the 1,000 old $100 par shares for 5,000 new no par shares *and* $400,000 debenture bonds; or,

(2) it was an exchange of the old stock for the new stock, *followed by* a distribution of the bonds as a dividend.

If the former, since the old stock which was exchanged in part for the bonds had been held by petitioner for 9 years, any gain realized from the exchange was taxable as a capital gain under Section 117.

The Tax Court found expressly that the transaction in question was an **exchange** of the old common stock for the new common stock **and** the debenture bonds.[7] In describing the plan of reorganization, it said:

> "The corporation was to issue **in exchange for the old stock**, the new stock **and** the debenture bonds . . ." (R. pp. 92a-93a.)

(7) In *Flanagan v. Helvering*, 116 F. (2d) 937, cited by the Circuit Court, there was admittedly a redemption of part of the corporation's stock, which the Tax Court held not to have been a partial liquidation but essentially equivalent to the distribution of a taxable dividend taxable as such under Sec. 115 (g).

In the case at bar, however, the Tax Court did not find, as it did in *Edith B. Bass*, 45 B. T. A. 1117, 1120-21 (see also 129 F. (2d) 300), that the transaction was an independent distribution not part of a unitary exchange.

> "**Pursuant to the plan**, the stockholders on March 16, 1939, delivered their 1,000 shares of common stock to the corporation and received from the corporation the 5,000 shares of its new common stock and debenture bonds in the aggregate principal amount of $400,000." (R. 93a-94a.) (Emphasis supplied.)

At the end of the first paragraph of its opinion the Tax Court again characterizes the transaction as "**an exchange of stock for stock and securities** of the same corporation" (R. p. 96a.)

The Tax Court also found the facts in the stipulation (R. 90a), paragraphs 10, 12 and 18 of which (R. 16a-18a) stated that the shares of new common stock and the debenture bonds were issued by the company **in exchange** for the shares of $100 par stock previously outstanding.

Under the record admissions and allegations by the Commissioner in this case, the Tax Court could not have found otherwise.

In his income tax return for 1939 petitioner had returned no gain from the receipt of the new stock and bonds in the recapitalization, taking the position that, under Section 112 (b) (3) and 112 (g) of the Act, no gain or loss was properly recognizable therefrom.

The Commissioner, however, increased petitioner's taxable income by $319,200, explaining such increase in the deficiency notice (R. 17a) as follows:

> "'(a) Other income has been increased $319,200 representing the fair market value of bonds of J. Robert Bazley, Inc., **received in exchange of common stock of that corporation.**'" (Emphasis supplied.)

In his petition to the Tax Court contesting the additional assessment based on the above, petitioner alleged, under paragraph V-(5) and (6) (R. pp. 5a-6a):

> "(5) **Pursuant to the Plan** of Reorganization and Recapitalization, **the corporation exchanged** the 5000 shares of new common stock without par value **and**

$400,000. of principal amount of debenture bonds for the 1000 shares of common stock outstanding. The exchange was made on the basis of 5 shares of new common stock without par value and $400. of debenture bonds for each share of old common stock outstanding. The 1000 shares of old common stock were then cancelled on the books of the corporation.

"(6) The Petitioner in April, 1939, pursuant to and in accordance with the terms of the Plan of Reorganization and Recapitalization received in exchange for his 798 shares of $100. par value common stock of J. Robert Bazley, Inc., 3990 shares of no par value common stock and $319,200. principal amount of 20 year 6% debenture bonds of the same corporation. . . .

. . . . . .

"In the further alternative, if it be held that Petitioner realized taxable income or gain in 1939 as a result of the foregoing exchange, then Petitioner contends that the Commissioner erred in determining that such income or gain was ordinary income instead of capital gain as provided by Section 117 of the Internal Revenue Code." (Emphasis supplied.)

In the Commissioner's answer to the above paragraphs of the petition, he alleged:

"(5) Admits that said corporation exchanged 5,000 shares of new common stock without par value and $400,000.00 of principal amount of debenture bonds for the 1,000 shares of old common stock outstanding; admits that the exchange was made on the basis of 5 shares of new common stock without par value and $400.00 of debenture bonds for each share of old common stock; admits that the 1,000 shares of old common stock were then cancelled; denies the remaining allegations of paragraph V (5) of the petition.

"(6) Admits that in April, 1939, petitioner received in exchange for his 798 shares of $100.00 par

value old common stock of J. Robert Bazley, Inc., 3,990 shares of no par new common stock of said corporation and $319,200.00 principal amount of 20-year 6% debenture bonds of said corporation; denies the remaining allegations of the first sentence of paragraph V (6) of the petition; * * * denies the remaining allegations and opposes the remaining contentions made by petitioner in said paragraph V (6) of the petition." (R. pp. 12a-13a.) (Emphasis supplied.)

In this Court's opinion in *Dobson v. Commissioner*, 320 U. S. 489, at page 502, the Court said:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact."

In disregard of the above ruling by this Court, in spite of the express admissions by the Commissioner on which were based express findings of the Tax Court above quoted, the majority of the Court below, as clearly shown by the last paragraph of its original opinion (R. p. 116), treated the transaction as one involving an exchange of the old stock for the new stock "followed by a distribution of the 20 year debenture bonds."

Under the rule of *Dobson v. Commissioner*, it is not the function of the Circuit Courts to alter the primary findings of fact by the Tax Court in order to sustain its legal conclusions, any more than to reverse them.

Respectfully submitted,

HENRY S. DRINKER,
For Petitioner.

ADDENDUM.

PERTINENT PROVISIONS OF THE CODE AND REGULATIONS.

(Emphasis in the text supplied throughout.)

CODE SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) **General rule.**—Upon the sale or exchange of property the **entire** amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

SEC. 112 (b). EXCHANGES SOLELY IN KIND.

(2) Stock for Stock of Same Corporation.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

SEC. 112 (b) (3). Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

SEC. 112 (g). DEFINITION OF REORGANIZATION.—As used in this section and section 113—

(1) the term "reorganization" means * * * (E) a recapitalization, * * *.

REGULATIONS 103, SEC. 19.112 (g)-2. **Definition of terms.**—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1): * * *

A "recapitalization," and therefore a reorganization, takes place if, for example—

* * * * * *

(3) **A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or**

* * * * * *

SEC. 112 (c). GAIN FROM EXCHANGES NOT SOLELY IN KIND.

(1) If an exchange would be within the provisions of subsection (b) * * * (2) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, **to the recipient shall be recognized**, but **in an amount not in excess** of the sum of such money and the **fair market value of such other property.**

(2) If a distribution made in **pursuance of a plan of reorganization** is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) Definition of dividend.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2)

out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(c) Distributions in liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. * * *

(g) Redemption of stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

SEC. 117. CAPITAL GAINS AND LOSSES.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months..

FILE COPY

IN THE

Supreme Court of the United States

No. 287.

October Term, 1946.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR PETITIONER.

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INDEX TO BRIEF FOR PETITIONER.

	Page
OPINIONS BELOW	1
JURISDICTION	2
QUESTIONS PRESENTED	2
STATUTES INVOLVED	3
STATEMENT OF THE CASE	3
SPECIFICATION OF ERRORS TO BE URGED	6
SUMMARY OF ARGUMENT	7
ARGUMENT	10
I. The Transaction Was a Recapitalization From Which Under Sections 112 (b) (3) and 112 (g) No Taxable Gain or Loss Was Recognized	10
In Order to Qualify as a Reorganization Under the Rule of the Gregory Case, a Recapitalization Need Not Have Been Effected to Benefit the Corporation	10
Origin of the "Corporate Business Purpose" Test	17
The Basic Unsoundness of the Tax Court's Test	18
The Tax Court Has Invented a Test so Vague as to be Practically Unworkable	19
The Corporate Benefit Test Is Contrary to the Commissioner's Regulations	21
The Dissenting Opinion	22
The Tax Saving Deduction on Account of the Interest on the Bonds	22

INDEX TO BRIEF FOR PETITIONER—Continued.

Page

II. If the Exchange Is Not Viewed as a Reorganization Non-Taxable Under Section 112 (b) (3), It Is Nevertheless an Exchange Under Section 112 and by Section 112 (b) (2) and Section 112 (c) (1) Is Taxable Under Section 117 23

Petitioner Did Not and Will Not, by Means of the Recapitalization, Escape Any Tax to Which, But for It, He Would Have Been Subjected ... 23

The Court Below Disregarded the Essential Primary Finding by the Tax Court That the Transaction Was a Unitary Exchange of Old Stock for New Stock and Bonds 24

CONCLUSION 34

ADDENDUM A.—Pertinent Provisions of the Internal Revenue Code and Treasury Regulations.. 37

ADDENDUM B.—Analysis of Decisions by the Tax Court Subsequent to Gregory, and Sustaining Recapitalizations Which Were Primarily or Exclusively for the Benefit of the Stockholders 53

TABLE OF CASES CITED.

	Page
Adams, 4 T. C. 1186; 5 T. C. 351	18, 63
Ahles Realty Corp. v. Commissioner, 71 F. (2d) 150	29
Annis Furs, Inc., Docket No. 110,894, unreported, C. C. H. Dec. No. 12,945 (M), 2 T. C. 1096	60
Ardbern Co., Ltd., 41 B. T. A. 910	56
Bailey, Walter C., Estate of, 37 B. T. A. 647	17
Bass, Edith B., 45 B. T. A. 1117	25, 57
Bedford, Estate of, Commissioner v., 325 U. S. 283	9, 33
Bingham's Trust v. Commissioner, 325 U. S. 365	28
Burnham v. Commissioner, 86 F. (2d) 776	11
Capento Sec. Corp., 47 B. T. A. 691	59
Capento Sec. Corp., Commissioner v., 140 F. (2d) 382	17, 59
Claude Neon Lights, Inc., 35 B. T. A. 424	17
Clayton and Hooks v. Commissioner, Memo Dec. Docket Nos. 109416, 109427, unreported; C. C. H. Dec. #14,111 (M)	29, 63
Cogan, Philip J., 36 B. T. A. 639	17
Court Holding Company v. Commissioner, 324 U. S. 331	11
Dobson v. Commissioner, 320 U. S. 489	6, 24, 28, 29
Docherty, Edgar M., 47 B. T. A. 462	59
Electrical Securities Corp., 34 B. T. A. 988	17
Electrical Securities Corp. v. Commissioner, 92 F. (2d) 593	17
Fischer, Jacob, 46 B. T. A. 999	57
Flanagan v. Helvering, 116 F. (2d) 937	25
Flanders Investment Co., 33 B. T. A. 483	17
Frank, Isaac W., Trust of 1927, 44 B. T. A. 934	56
Franklin, Harold B., 34 B. T. A. 927	17
General Motors Corp., 35 B. T. A. 523	17
Gilmore, Anna V., 44 B. T. A. 881	56

TABLE OF CASES CITED—Continued.

Page

Gilmore's Estate, Commissioner v., 130 F. (2d) 791, 17, 24, 56, 64
Globe-News Co. v. Commissioner, 3 T. C. 1199 ..... 29, 64, 65
Graham, George D., 37 B. T. A. 623 17
Gregory v. Helvering, 69 F. (2d) 809 16
Gregory v. Helvering, 293 U. S. 465, 2, 4, 6, 7, 11, 12, 13, 17, 23, 64
Griffiths v. Commissioner, 308 U. S. 355 16
Handbird Holding Corp., 32 B. T. A. 238 17
Hartzell, Elmer W., 40 B. T. A. 492 55
Heady, Marion, Docket No. 5812, 5813, unreported, C. C. H. Dec. No. 14,702 (M) 63
Humko Co., Docket No. 112,235, 79, unreported, C. C. H. T. C. Service Dec. 13,642 (M) 18, 61
J. D. and A. B. Spreckels Co., 41 B. T. A. 370 55
Johnson, James Lee, 37 B. T. A. 155 17
Kirby, Leila S., 102 F. (2d) 115 ..... 64, 65
Kleeman, Arthur S., 35 B. T. A. 17 17
Knapp Monarch Co. v. Commissioner, 139 F. (2d) 863 ..... 18, 64
Kolb, Commissioner v., 100 F. (2d) 920 ..... 11, 18
L. & E. Stirn, Inc., 39 B. T. A. 143 53
Lea, Helen Sperry, 35 B. T. A. 243 17
Loewenberg, Belle G., 39 B. T. A. 844 17
Lyon, Inc., 42 B. T. A. 1094 56
Lyon v. Commissioner, 127 F. (2d) 210 ..... 17, 56
Marcher, Royal, 32 B. T. A. 76 17
McCormick, Robert R., Exec., 33 B. T. A. 1046 17
Mellon, A. W., 36 B. T. A. 977 17
Minnesota Tea Co. v. Helvering, 89 F. (2d) 711 29
Minnesota Tea Co. v. Helvering, 296 U. S. 378 16
Morainville v. Commissioner, 135 F. (2d) 201 ..... 18, 64
Morgan Mfg. Co. v. Commissioner, 124 F. (2d) 602 17
Morgan, Robert M., 41 B. T. A. 379 17
Munroe, C. A., 39 B. T. A. 685 55

TABLE OF CASES CITED—Continued.

	Page
National Investors Corp. v. Hoey, 144 F. (2d) 466	17
Neustadt, Commissioner v., 131 F. (2d) 528	11
Okonite Co., 4 T. C. 618, affirmed 155 F. (2d) 248	64
Peck & Peck, 42 B. T. A. 651	56
Perkins, Thomas N., 33 B. T. A. 606	17
Pickard, Sam., 40 B. T. A. 258	17
Prairie Oil & Gas Co. v. Motter, 66 F. (2d) 309	29
Redford Lumber Co. (Memo op. Docket No. 106560, C. C. H. Dec. 12,865 (B)	11
Schoo, Clarence J., 47 B. T. A. 459	11, 58
Skenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268	18, 29, 64
Segall, Karl B., 38 B. T. A. 43	11
Smith, John Thomas, Commissioner v., 136 F. (2d) 556	17
Snow, George Palen, Docket No. 107,390, unreported, C. C. H. Dec. No. 12,908 (M)	56
Souther, Chester A., 39 B. T. A. 197	53
South Atlantic S. S. Co. v. Commissioner, 42 B. T. A. 705	11, 29, 64, 65
Southwest Consolidated Corp., Helvering v., 315 U. S. 194	11
Sprouse, Commissioner v., 318 U. S. 604	23
Starr v. Commissioner, 82 F. (2d) 964	29
Tyson v. Commissioner, 146 F. (2d) 50	17
Von's Investment Co., Ltd., 33 B. T. A. 30	17
Watts, Helvering v., 296 U. S. 387	7, 11
Wellhouse, Louis, Jr., 3 T. C. 363	62
W. & K. Holding Corp., 38 B. T. A. 830	17

STATUTES CITED.

(All Printed in Addendum A to Brief, pp. 37-52.)

Page

Internal Revenue Code, 53 Stat. (Part I); 26 U. S. C. A.:

Sec. 111, 53 Stat. 37 ..... 30, 31, 32, 34, 37
Sec. 112 (a), 53 Stat. 37 38
Sec. 112 (b) (2), 53 Stat. 37 ... 2, 6, 8, 9, 31, 32, 33, 35, 40
Sec. 112 (b) (3), 53 Stat. 37 ..... 2, 4, 5, 6, 7, 8, 9, 10, 11, 15, 19, 23, 26, 31, 32, 34, 35, 40
Sec. 112 (c) (1), 53 Stat. 39 ..... 2, 6, 8, 9, 23, 31, 32, 33, 34, 35, 46
Sec. 112 (c) (2), 53 Stat. 39 ..... 9, 33, 46
Sec. 112 (g) (as amended 1939), 53 Stat. 870, 2, 6, 7, 16, 15, 19, 26, 35, 40
Sec. 115 (a), 53 Stat. 46 ..... 29, 46
Sec. 115 (c), 53 Stat. 46 48
Sec. 115 (g), 53 Stat. 48 ..... 2, 5, 9, 25, 29, 48
Sec. 115 (h), 53 Stat. 48 49
Sec. 117, 53 Stat. 50 ..... 2, 5, 6, 8, 9, 23, 32, 34, 35, 51, 52

Judicial Code—48 Stat. 938, Sec. 240 (a) (U. S. C. A., Title 28, Sec. 347) 2

TREASURY REGULATIONS CITED.

(All Printed in Addendum A to Brief, pp. 37-52.)

	Page
Reg. 103:	
Sec. 19.111-1	38
Sec. 19.112 (a)-1	38
Sec. 19.112 (b) (2)-1	31, 40
Sec. 19.112 (c)-1	31, 46
Sec. 19.112 (g)-1	41
Sec. 19.112 (g)-2	21, 22, 43
Sec. 19.112 (g)-3	44
Sec. 19.112 (g)-4	45
Sec. 19.115-9	48
Sec. 19.115-11	50
Sec. 19.117-2	52

IN THE

Supreme Court of the United States

No. 287. October Term, 1946.

J. ROBERT BAZLEY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR PETITIONER.

This case comes before the Court on writ of certiorari issued to review a decree of the United States Circuit Court of Appeals for the Third Circuit.

OPINIONS BELOW.

The opinion of the Tax Court of the United States, written by Judge Opper, from which Judges Smith, Arundell, Van Fossan, Black and Tyson dissented, together with the dissenting opinion by Judge Smith, promulgated February 28, 1945, appears in the Record at pages 89a to 104a, and is reported at 4 T. C. 897. The opinion of the United States Circuit Court of Appeals for the Third Circuit on the original argument, written by Circuit Judge O'Connell, was filed January 8, 1946, and appears in the Record at pages 106 to 116 inclusive. This opinion was withdrawn by the Court April 8, 1946 (R. 125-126) and was not officially reported. The opinion of the majority of the Circuit Court of Appeals on rehearing, written by Circuit Judge O'Connell was filed April 16, 1946, and appears in the Record at pages 126 to 136 inclusive and is reported at 155 F. (2d) 237. The dissenting opinion by Judges Maris and Goodrich on rehearing, filed the same day, appears in the Record at pages 137 to 140 inclusive, and is reported at 155 F. (2d) 244.

JURISDICTION.

The jurisdiction of this Court to review the judgment of the Circuit Court of Appeals for the Third Circuit on writ of certiorari is provided by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (43 Stat. 938, 28 U. S. C. A. Sec. 347), and Section 1141 (a) of the Internal Revenue Code (53 Stat. Part. 1, 164, 26 U. S. C. A. Sec. 1141). The judgment of the United States Circuit Court of Appeals was entered on April 16, 1946. (R. p. 141.) Petition for writ of certiorari was granted by this Court on October 14, 1946.

QUESTIONS PRESENTED

1. Did the receipt by petitioner of debenture bonds (together with new common stock) of J. Robert Bazley, Inc., pursuant to the Plan of Reorganization of that Corporation duly adopted, whereby the entire 1,000 shares of previously outstanding $100 par stock (including petitioner's 798 shares) were exchanged for its 5,000 new no par shares *and* $400,000 6% debenture bonds, give rise to a non-recognized gain, the taxation of which was postponed under Sections 112 (b) (3) and 112 (g) of the Internal Revenue Code, or did it constitute a dividend taxable under Section 115 (g)?

2. Under *Gregory v. Helvering*, 293 U. S. 465, must it affirmatively appear, in order that such "recapitalization" come within Sections 112 (b) (3) and 112 (g), that it was adopted and carried out for the benefit of the *corporation* as distinguished from a benefit to *stockholders*?

3. Was the Plan adopted and carried out pursuant to a "legitimate corporate business purpose"?

4. If the receipt of such debentures with such new common stock in the exchange for old common stock (which petitioner had held for nine years) did *not* constitute such a "recapitalization", was not the gain realized therefrom a gain from an exchange, taxable as capital gain under Sections 112 (b) (2), 112 (c) (1) and 117?

STATUTES INVOLVED.

The pertinent provisions of the Internal Revenue Code and of the Treasury Department Regulations are set forth in Addendum A.

STATEMENT OF THE CASE.

In 1939 petitioner's company, of which he and his wife owned practically all the outstanding stock (1,000 $100 par shares) was engaged in the contracting business, principally in "stripping" the earth and rock overlying veins of anthracite coal. This business being then very poor, petitioner's Company considered going into the hazardous business of road building which, as found by the Tax Court (R. 91a) "requires considerable working capital", and in which "many road-building contractors have failed". The Company having accumulated a surplus of $855,783.82, most of which had been ploughed back into plant and equipment, it was deemed advisable to rearrange the company's capital structure so that less would be represented by the stock, both in order to leave less at the risk of the business and in order to reduce the unit value of the shares. Accordingly, a recapitalization was duly effected under Pennsylvania law, the outstanding 1,000 shares of $100 par stock being exchanged for 5,000 no par shares and $400,000 principal amount of 20 year 6% debenture bonds.

The Tax Court found four "reasons for adopting the transaction" (R. pp. 91a-92a):

1. The stockholders, in receiving in exchange for the outstanding 1,000 shares, debentures as well as no par stock, would have, in part, a more marketable security, which would be particularly advantageous where necessary to liquidate a part of a deceased stockholder's investment in order to meet inheritance taxes and other expenses.

2. The debentures could be sold by the stockholder where necessary without reducing the stock control in the management of the Company.

3. The debentures would constitute a preferred obligation which, in case of eventual reverses incident to the hazardous road building in which the company was embarking, would share with creditors.

4. By reason of the fact that a large part of the company's earnings had been reinvested in fixed assets, it was deemed proper that the part of the earned surplus represented by the increased stated value of the common stock and by the par value of the bonds should be transferred from earned surplus to capital, and no longer be available for dividends, but "reflect a more permanent dedication to corporate use of these earnings".

The Tax Court refused to credit petitioner's testimony that an additional reason was that petitioner and his associates deemed it desirable, by reducing the unit value of the stock, to make it feasible to sell some of it to the key employees and so give them a stake in the business,—because this had not in fact been done up to the time of the hearing. Petitioner, while pointing out that the company's capital structure had in fact been altered so as to make such a future sale feasible, does not, for the purpose of this appeal, dispute the Tax Court's finding.

The Tax Court held that the four reasons which it found had motivated the recapitalization were all reasons which benefited the *stockholders* as distinguished from the *corporation*. Construing this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465, a majority of the Tax Court held, (applying such construction for the first time in this case) that, although this was a transaction within the terms of section 112 (b) (3) [1] of the Act, and although the debentures were admittedly "securities" thereunder, nevertheless, in order for a recapitalization or other reorganiza-

(1) Sec. 112 (b) (3) "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Sec. 112 (g) "As used in this section . . . (1) The term 'reorganization' means . . . (E) a recapitalization."

tion to come within such provisions it must have been undertaken for and result in a benefit to the *corporation* as distinguished from one to the *stockholders;* accordingly, since the majority of the Tax Court found no corporate business purpose, it held that the transaction was not within sections 112 (b) (3) and (g) and was therefore subject to tax. They also refused to recognize any benefit to the corporation in the alteration of its capital structure in the manner which the stockholders desired, or in the saving of taxes to the corporation by the deduction of the annual interest charge on the debentures.

Five of the sixteen Judges of the Tax Court dissented.

The Circuit Court, Judges Maris and Goodrich dissenting, upheld the position of the majority of the Tax Court.

The second point in the case was, assuming that the transaction did not constitute a tax-free reorganization because lacking a "corporate business purpose," nevertheless, since under the express allegations and admissions of the Commissioner and the express findings of the Tax Court it constituted a *single unitary transaction,*—the receipt of the new stock *and* debentures *in exchange* for the old stock, which had been held for 9 years,—any resulting gain was taxable as a *capital gain* under Section 117.

On this second point the Tax Court attempted no logical reconciliation of its *finding of fact* [2] that the transaction was a unitary exchange of old stock for new stock *and* debentures, with its *conclusion* that the distribution of the debentures was a taxable dividend. The Circuit Court in its original opinion (R. pp. 106-116), attempted to sustain the Tax Court's conclusion by revising the Tax Court's express finding that the transaction was a single exchange of old stock for new stock and bonds, and by dividing the transaction into two distinct steps,—an exchange of the old stock for new stock "followed by a distribution of the 20-year debenture bonds." The Circuit Court's attention having been called, on the reargument, to the Commission-

(2) See *infra hereto*, p. 25.

er's express allegations and admissions that this was a single exchange and the Tax Court's finding to the same effect, the majority, in its revised opinion, ignored the Tax Court's finding to the effect that the exchange was a single transaction, and omitted the reference which it had made at the end of its first opinion to this Court's statement in the *Dobson* case[3] that "whether an apparently integrated transaction shall be broken up into several separate steps" is a question of fact on which the Tax Court's finding is controlling.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals erred:

1. In holding that a recapitalization, planned and duly consummated for bona fide purposes other than tax avoidance, was not within the provisions of Sections 112 (b) (3) and 112 (g) of the Revenue Act because not undertaken for the benefit of the corporation as distinguished from that of the stockholders.

2. In supporting the Tax Court in its construction of this Court's opinion in *Gregory v. Helvering*, 293 U. S. 465 as so stating the law.

3. In holding that the plan in question was not adopted and carried out pursuant to a "legitimate corporate business purpose."

4. In ignoring the Tax Court's finding of fact that the recapitalization under review consisted of a unitary exchange of old stock for new stock *and* debenture bonds, and holding that it consisted of an initial exchange of old stock for new stock *followed by* a distribution of the debentures, which constituted a taxable dividend, whereas, assuming that this was not a tax free "reorganization" under Section 112, the gain resulting under Section 112 (b) (2), (c) (1), was a capital gain, taxable under Section 117.

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(3) *Dobson v. Commissioner*, 320 U. S. 489, 502.

SUMMARY OF ARGUMENT.

I. The Transaction in Question Was a Recapitalization From Which, Under Sections 112 (b) (3) and 112 (g) No Taxable Gain Was Recognized.

Both the Tax Court and the Court below recognize that the exchange of all the outstanding stock of a corporation for its new stock *and* bonds constitutes a technical recapitalization and thus a reorganization under Section 112 of the Internal Revenue Code. *Helvering v. Watts*, 296 U. S. 387.

Gregory v. Helvering, 293 U. S. 465, did not hold that, in order to qualify as tax free, a "recapitalization" must be undertaken for the benefit of the *corporation* as distinguished from its *stockholders*. What it held was that where a dummy corporation is formed and used for the sole purpose of avoiding an impending tax liability, and is dissolved as soon as that purpose has been accomplished, it having in the meantime served no legitimate business purpose, it may be disregarded, and the transaction viewed in its true light, since the term "reorganization" does not contemplate a sham transaction adopted for the sole purpose of tax avoidance by means of a dummy corporation having no business function.

This Court did not, as the majority of the Tax Court and of the Court below would apparently have it appear, speak of a "corporate business purpose." This Court merely referred to the dummy corporation as "an operation having no business or corporate purpose."

The idea that the *Gregory* case condemns a "recapitalization" (not undertaken or effective for the sole purpose of avoiding taxes), unless this be demonstrably for the benefit of the corporation, is an invention of the Tax Court and unsupported by any other court except the majority of the Court below. The fact that the change in capitalization is adopted by the stockholders for *reasons other than tax avoidance* renders the *Gregory* case inapplicable.

In none of the later decisions by this Court has the *Gregory* decision been interpreted or extended as the Tax Court and the Court below would have it appear. In all of them the decision was understood merely to prescribe the disregarding of sham corporations formed and used for the sole purpose of tax avoidance.

The Tax Court expressly found four features in which the recapitalization was for the benefit of the stockholders in connection with matters having no relation to tax avoidance. The minority also found a benefit to the corporation in reducing its annual taxable income by the annual interest charge on the bonds. Furthermore, the recapitalization benefited the corporation by reducing the unit value of the shares so as to make it possible for the stockholders to sell a portion of such shares to employees, even though they had no intention of immediately doing so.

II. If the Exchange Is Not Viewed as a Reorganization Non-Taxable Under Section 112 (b) (3), It Is Nevertheless an Exchange Under Section 112 and by Section 112 (b) (2) and Section 112 (c) (1) Is Taxable Under Section 117.

Admittedly the new stock and bonds were received *in exchange for* the old stock. In view of this, it is impossible to split up the transaction and treat the issue of the bonds as a taxable dividend issued to petitioner by reason of his *ownership* of the old stock, and not in *exchange* for part of it.

No tax liability was impending against petitioner or the corporation. He realized no actual or present gain on receipt of the debentures. If, as and when they are sold by him or redeemed or paid off at maturity he will be subject to tax at the capital gains rate, just as he would be if he had sold that part of his stock which was exchanged for them. He has escaped no tax and will escape none which he should properly pay. Continuity of control was not affected, in the slightest degree, by the recapitalization.

The transaction, being an exchange, clearly comes under Section 112. If, as the Tax Court holds, the absence of legitimate corporate business purpose prevents it from being a reorganization and hence from coming under Section 112 (b) (3), it is nevertheless clearly within 112 (b) (2), and 112 (c) (1), being an exchange of common stock for common stock plus "other property"—debentures—constituting taxable gain. This "other property," having been received in the exchange and his original stock having been held for more than 24 months, under Section 111 the gain realized, to the extent recognized by 112 (b) (2) and 112 (c) (1) is taxable at the capital gains rate provided by Section 117. Since by hypothesis the exchange is not in a reorganization, Section 112 (c) (2) is by its terms inapplicable. Under the decision of this Court in *Commissioner v. Bedford*, 325 U. S. 283, a transaction which comes within Section 112 cannot be taken out of the requirements of Section 112 and forced into the mould of Section 115 as a taxable dividend. While in that case, since the exchange was in a reorganization under 112 (b) (3) and 112 (g), the extra cash was taxable as a dividend under Section 112 (c) (2); in the case at bar, if it be not a reorganization under Section 112 (b) (3) it comes under Section 112 (b) (2) and 112 (c) (1), and the gain represented by the debentures is taxable as capital gain under Section 117.

Argument.

I. THE TRANSACTION WAS A RECAPITALIZATION FROM WHICH UNDER SECTIONS 112 (b) (3) AND 112 (g) NO TAXABLE GAIN OR LOSS WAS RECOGNIZED.

Sec. 112 (b) (3) "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Sec. 112 (g) "As used in this section . . . (1) The term 'reorganization' means . . . (E) a recapitalization."

In Order to Qualify as a Reorganization Under the Rule of the Gregory Case, a Recapitalization Need Not Have Been Effected to Benefit the Corporation.

The corporate proceedings here involved obviously constituted a "recapitalization." The Tax Court said of it (R. p. 96a):

> "Looking only at the language of the reorganization section, there was a technical recapitalization: that is, a reorganization within the statutory definition of section 112 (g) (1) (D). *Annis Furs, Inc.*, 2 T. C. 1096; *Clarence J. Schoo*, 47 B. T. A. 459, appeal dismissed (C. C. A., 1st Cir.). And since there was an exchange of stock for stock and securities in the same corporation, the language of the section forbids recognition of gain or loss. Section 112 (b) (3)."

In *Helvering v. Southwest Consolidated Corporation*, 315 U. S. 194, this Court defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."

That an exchange of all the outstanding stock of the corporation for its new stock *and* bonds constitutes a "recapitalization" and hence a "reorganization" under Section 112 has been held by this Court as well as by the Circuit Courts and the Tax Court.[1]

A majority of the Court below, however, sustained the majority of the Tax Court in holding that under *Gregory v. Helvering*, 293 U. S. 465, in order to qualify a recapitalization as tax free under 112 (b) (3) it must appear that it had as its objective what the Tax Court terms a "legitimate corporate business purpose," constituting a benefit to the corporation as distinguished from a benefit to the stockholders.

But *Gregory v. Helvering*, 293 U. S. 465, did not hold that, in order to qualify as tax free, a "recapitalization" must be undertaken for the benefit of the *corporation* as distinguished from its *stockholders*. What it held was that where a dummy corporation is formed and used for the sole purpose of avoiding an impending tax liability, and is dissolved as soon as that purpose has been accomplished, it having in the meantime served no legitimate business purpose, it may be disregarded, and the transaction viewed in its true light, since the term "reorganization" does not

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(1) *Helvering v. Watts*, 296 U. S. 387 (1935) (Serial Mortgage Bonds).
Commissioner v. Kolb, 100 F. (2d) 920 (1938) (10 Yr. Debenture Bonds).
South Atlantic Steamship Line, 42 B. T. A. 705 (1940) (25 Yr. Deb. Bonds).
Clarence J. Schoo, 47 B. T. A. 459 (1942) (25 Yr. Debenture Bonds).
Redford Lumber Co. (Memo op. Docket #106560, C. C. H. Dec. 12,865-B) (Debenture Notes).

See also:
Burnham v. Commissioner, 86 F. (2d) 776 (1936); cert. den. 300 U. S. 683 (1937) (Unsecured 10 Year Notes).
Commissioner v. Neustadt, 131 F. (2d) 528 (1942) (20 Yr. Debenture Bonds).
Karl B. Segall, 38 B. T. A. 43 (Debenture Notes).

contemplate a sham transaction adopted for the sole purpose of tax avoidance by means of a dummy corporation having no business function.

Nor did this Court there speak, as the Tax Court and the majority of the Court below would apparently have it appear, of a "corporate business purpose." This Court merely referred to the dummy corporation as "an operation having no business or corporate purpose."

The distinction is between a sham reorganization where a corporation is formed for the sole and direct purpose of insulating a stockholder or a corporation from an impending tax, and genuine reorganizations having an objective other than tax avoidance, the result of which may be to reduce future taxes. As Justice Black said in the recent decision in *Court Holding Company v. Commissioner*, 324 U. S. 331, 334, "formalisms which exist solely to alter tax liabilities" cannot be availed of for that purpose.

In the argument of the case at bar in the Circuit Court of Appeals, respondent specifically admitted that the recapitalization was real and not a sham. On page 28 of their brief in the Court below respondent said:

> "*It is not disputed that the new common stock and debentures issued in the recapitalization were real and gave the recipients the rights in the Corporation which they purported to do, as taxpayer argues.* (Br. 36.) But the question here is whether what was done was inspired by purposes having a substantial relation to the Corporation's business, so that the recapitalization may be given effect for tax purposes." (Emphasis supplied.)

The essential facts of the *Gregory* case, in which this Court affirmed the decision of the Circuit Court of Appeals for the Second Circuit reversing the Board of Tax Appeals, are succinctly stated at the beginning of this Court's opinion (emphasis supplied):

"Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. *For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit*, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a 'reorganization' under section 112 (g) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 818, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation as capital net gain the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction." (p. 467)

It will be noted that the *Gregory* case was not a recapitalization in which the security holders merely desired to "reshuffle" the "capital structure within the framework" of the corporation. It was in its essence and ultimate analysis a sale by the sole stockholder of corporate assets which the stockholder did not wish to receive as a dividend, but sought to effect through a dummy corporation formed and used for the sole purpose of minimizing the stockholder's

taxes and whose only function was to acquire such assets in order that it might be promptly dissolved and give them to the stockholder for sale by her.

After quoting the applicable provisions of the Act of 1928, this Court held (emphasis supplied):

"It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that *if a reorganization in reality was effected* within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States v. Isham*, 17 Wall. 496, 506; *Superior Oil Co. v. Mississippi*, 280 U. S. 390, 395-6; *Jones v. Helvering*, 63 App. D. C. 204; 71 F. (2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

"When subdivision (B) *speaks of a transfer of assets by one corporation to another, it means a transfer made* 'in pursuance of a plan of reorganization' (Section 112 (g)) of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation *having no business or corporate purpose* a mere device which put on the form of a corporate

reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of *corporate shares* to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

"In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance *masquerading as a corporate reorganization*, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." (pp. 468-470)

The *Gregory* case clearly holds that, where a reorganization involves a transfer of property from one corporation to another, in order to come within the statutory definition of "reorganization" the transaction must pertain to the legitimate corporate purpose of the acting companies or one of them. It does not, however, hold (as the Court below and the Tax Court hold in this case at bar) that a "recapitalization" does not come within Section 112 (b) (3) and 112 (g) unless it affirmatively appears that it was planned and carried out to accomplish a "legitimate corporate business purpose" of the corporation which is re-

capitalized, as distinguished from a bona fide purpose of its stockholders.

The foregoing construction of the *Gregory* decision is confirmed by Judge Hand's opinion in the Court below which this Court there affirmed. In holding that the transaction was a mere tax-avoiding sham and no part of the legitimate business of either corporation, Judge Hand said (69 F. (2d) 809, 811):

> "The purpose of the section is plain enough; *men engaged in enterprises*—industrial, commercial, financial, or any other—might wish to consolidate, or *divide*, to add to, or subtract from, *their* holdings. Such transactions were not to be considered as 'realizing' any profit, *because the collective interests still remained in solution*. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'" (Italics ours.)

Clearly in the first sentence Judge Hand was referring to the desire of the stockholders to "consolidate, or divide, to add to, or subtract from, their holdings" for their advantage, irrespective of any specific benefit to the corporation other than to have a capital structure advantageous to its stockholders.

The same conclusion follows from an examination of the later decisions by this Court construing and applying the *Gregory* case.[2]

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(2) See *Helvering v. Minnesota Tea Co.*, 296 U. S. 378, 385, where this Court said of the Gregory decision:—

> "*Gregory v. Helvering*, 293 U. S. 465, revealed a sham—a mere device intended to obscure the character of the transaction. We, of course, disregarded the mask and dealt with realities. The present record discloses no such situation; nothing suggests other than a bona fide business move.

See also:

Griffiths v. Commissioner, 308 U. S. 355, 357-8.

Origin of the "Corporate Business Purpose" Test.

The idea that the *Gregory* case condemns a "recapitalization" (not undertaken or effective for the sole purpose of avoiding taxes), unless this be demonstrably for the benefit of the corporation, is an invention of the Tax Court and is unsupported by any other court except the majority of the Court below.

During the years following *Gregory v. Helvering*, that decision was applied by the Tax Court solely to cases similar to that there involved,—where the sole owner of the stock of a corporation desired to secure for sale to a prospective purchaser a portion of the corporation's assets, and for the purpose of avoiding the surtax which would result from receiving such assets as a dividend, organized a "conduit" corporation through which the asset should be passed and the dummy corporation be dissolved or become moribund, the transaction having been motivated solely by a desire to avoid an impending tax on a dividend, the *conduit corporation* conducting no real business, and the whole transaction constituting what the Tax Court terms a "sham", masquerading in the guise of a reorganization.[4]

Where the Board considered that the transaction was a genuine one and not a sham, it held in these early cases that the *Gregory* principle was inapplicable.[5]

Electrical Securities Corp. v. Commissioner, 92 F. (2d) 593, 594-5 (C. C. A. 2d).
Commissioner v. Gilmore's Estate, 130 F. (2d) 791, 795-6 (C. C. A. 3d).
Morgan Mfg. Co. v. Commissioner, 124 F. (2d) 602, 605 (C. C. A. 4th).
Lyon v. Commissioner, 127 F. (2d) 210, 213 (C. C. A. 6th).
Commissioner v. John Thomas Smith, 126 F. (2d) 556, 559 (C. C. A. 2d).
Commissioner v. Capento Sec. Corp., 140 F. (2d) 382, 385 (C. C. A. 1st).
National Investors Corp. v. Hoey, 144 F. (2d) 466, 468 (C. C. A. 2d).
Tyson v. Commissioner, 146 F. (2d) 50, 5[illegible] (C. C. A. 8th).

(4) See *Royal Marchant*, 32 B. T. A. 76; *Handbird Holding Corp.*, 32 Id. 238; *Penn's Investment Co., Ltd.*, 33 Id. 30; *Flinders Investment Co.*, 33 Id. 483; *Thomas N. Perkins*, 33 Id. 606; *Robert R. McCormick, Exec.*, 33 Id. 1046; *Harold B. Franklin*, 34 Id. 927; *Electrical Securities Corp.*, 34 Id. 988; *Arthur S. Kleeman*, 35 Id. 17; *Helen Sperry Lea*, 35 Id. 243; *Philip J. Cogan*, 36 Id. 639; *A. W. Mellon*, 36 Id. 977; *George D. Graham*, 37 Id. 623; *Estate of Walter C. Bailey*, 37 Id. 647; *W. & K. Holding Corp.*, 38 Id. 830; *Belle G. Loewenberg*, 39 Id. 844; *Sam Pickard*, 40 Id. 258; *Robert M. Morgan*, 41 Id. 370.

(5) *Claude Neon Lights, Inc.*, 35 B. T. A. 424; *General Motors Corp.*, 35 Id. 523; *James Lee Johnson*, 37 Id. 155.

In a number of cases the Board of Tax Appeals and the Tax Court has sustained recapitalizations which were clearly for the sole benefit of the stockholders, as distinguished from the independent corporate benefit, the distinction, later invented, not being discussed. These cases are collected in Addendum B to this brief *infra*, pp. 53-65.

Other recapitalizations, which were not claimed to have benefited the corporation as distinguished from the stockholders, have similarly been sustained by the Circuit Courts.[6]

The supposed necessity for a *corporate* business purpose as distinguished from a *stockholders'* objective, unrelated to tax avoidance, is a recent invention by the Tax Court, having been first definitely suggested in a dictum by Judge Harron in the case of *Humko Co.*,[7] decided by her in December, 1943, almost nine years after the *Gregory* decision. This test was applied by the Tax Court for the first time in the case at bar and in the companion case of *Adams*, 4 T. C. 1186; 5 T. C. 351.

The Basic Unsoundness of the Tax Court's Test.

It is a fundamental principle of corporation law that all activities within the scope of the corporate charter,—whatever the corporation may properly do for its corporate benefit, in the furtherance of its business,—are to be carried on by its board of directors. Stockholder action is required and appropriate only in connection with matters which concern the relation of the stockholders among themselves,—which modify the agreement among them incident to their formation of the corporation, with which matters the corporation itself is not directly concerned. Thus, the

(6) See
Commissioner v. Kolb, 100 F. (2d) 920, 926 (9th Circuit);
Skenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268 (2d Circuit);
Morainville v. Commissioner, 135 F. (2d) 201 (6th Circuit;
Knapp Monarch Co. v. Commissioner, 139 F. (2d) 863 (8th Circuit).

(7) Docket 112235, 79, unreported, but see C. C. H. T. C. Service, Dec. 13,642 (M). See *infra* Addendum B at p. 61 thereof.

directors alone may properly authorize the making of contracts. Under the laws of no State, however, may the directors change the capitalization by authorizing stock not provided for in the charter, or by altering the rights of the stockholders inter sese. These matters are for the *stockholders* and are a part of *their* business, not a part of the corporation's business.

The reorganization provisions of the Revenue Act are not confined, however, to matters within the scope of the corporation's business,—matters which may be regulated by the directors; see Sec. 112 (b) (3), 112 (g) (1). These provisions apply to the stockholders as well as to the corporation. Indeed, the provisions relative to recapitalization concern the stockholders primarily, if not exclusively. Neither the Tax Court nor respondent nor the majority of the Court below have suggested any reason why, as to recapitalizations, a "business purpose" test should apply only to the corporation and should not apply to the stockholders, whose action as such is necessary to bring it about. Nor have they explained how there can conceivably be a "corporate business purpose" in connection with something which may be no part of the corporation's business and which, through its board of directors, charged with regulating its business, it has no power to regulate.

The Tax Court Has Invented a Test so Vague as to be Practically Unworkable.

The disregard by the majority of the Tax Court and by the majority of the Court below of the fundamental principle above summarized would, if followed, introduce into the administration of Section 112 of the Revenue Act a test so vague and variable as to introduce lamentable uncertainty into the administration of the law. As the dissenting opinion of Judges Maris and Goodrich clearly demonstrates, what is for the benefit of the corporation, as distinct from that of the stockholders, and vice versa, is something on which no two lawyers, no two accountants or

no two business men could agree. To inject such a test as that proposed by the Tax Court into the administration of the law would render the soundness of a recapitalization under Section 112 dependent principally on the whim of the Revenue Agent, the Commissioner, or the Judge who passed on the case. It would also throw doubt on a great number of completed recapitalizations about which no previous doubt existed. For example, there have been and will doubtless be innumerable instances of recapitalizations, of corporations a majority or all of the entire capital stock of which is owned by a holding company which, for reasons of its own, desires to have the securities of a subsidiary in a different form,—stock for stock, bonds for stock, preferred of a different type, etc. There has never been any suggestiton that these recapitalizations are not tax free, although it is inconceivable that there could be any purpose except that of the holding company whose wishes the subsidiary is bound to carry out.

In the great majority of cases involving recapitalizations, the changes in the capital structure of a corporation are in reality advantageous only to the stockholders. For example, is there a demonstrable corporate advantage in the exchange of $100,000. par value 4% preferred stock and $100,000. par value of common stock for $80,000. par value 5% preferred and 1250 shares of no par common? What corporate advantage is there in the substitution of preferred stock for common stock, or in the recapitalization noted at the end of the dissenting opinion, where common stockholders arranged for a reclassification of part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control? If the rule here established be followed, it will set up a test of the validity of scores of recapitalizations so vague as to be wholly unpredictable, resulting in conclusions based on no substantial differences, in cases, all of which result in no change of continuity in control and in no present realization of actual gain to the stockholders, but merely

in a change in the form of the security. Such a radical departure from long existing practice and legal standards should, it is submitted, be effected, if intended, only by a prospective amendment to the law by Congress.

The Corporate Benefit Test Is Contrary to the Commissioner's Regulations.

The majority opinion by the Court below, sustaining the Commissioner's contention said (R. p. 135) that the Tax Court's "corporate benefit" test was pursuant to the Regulations by the Commissioner in effect since 1[illegible]. Such, however, is not the case; quite the contrary. The Regulation, interpreting the *Gregory* decision, merely provides that corporate readjustments, in order to qualify as reorganizations must be such "as are required by business exigencies." This clearly meant, as distinguished from a sham purpose by the stockholders to avoid tax. Where the Regulation provided that such reorganizations must be "undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization" it obviously intended merely to exclude a dummy corporation, formed solely to avoid taxes, having no business and dissolved immediately its purpose was accomplished.

That the Regulation was not intended and was never interpreted as laying down a "corporate business" test for recapitalization is conclusively demonstrated by Regulations 103, Sec. 19.112 (g)-2 (*infra* p. 43-44 hereof), where in describing what constitutes a "recapitalization" under the reorganization provisions of the law the Commissioner gives four examples (omitted in the extract from the Regulations annexed to respondent's brief in the Court below) of what constitutes such statutory "recapitalization". Nowhere is it stated in the Regulation that these changes in capitalization must, in order to qualify as a recapitalization, be prompted by a corporate as distinguished from a stockholder's purpose. The third example of a recapitalization qualifying as tax-free is (*infra*, p. 43):

"(3) a corporation issues preferred stock previously authorized but unissued for outstanding common stock."

It is, we submit, impossible to find or imagine any benefit to the corporation, as such, by the substitution of preferred for common stock. The sole benefit would be to those common stockholders who received preferred stock for their common. Neither the majority of the Tax Court nor that of the Court below explain or even refer to this Regulation, although we quoted it in our brief below and emphasized it particularly in the oral argument.

The Dissenting Opinion.

The dissenting opinion by Judges Maris and Goodrich contains so clear and concise an analysis of the legal principles which these two judges apply to the Tax Court's findings of fact, that we find it impossible to summarize or abstract it. Accordingly, we refer to it, as printed on pages 137-140 of the Record, for a clear exposition of the fallacy of the Tax Court's "corporate business purpose" theory.

The Tax Saving Deduction on Account of the Interest on the Bonds.

The benefit to the corporation by the saving of taxes resulting from the interest charge on the bonds was ignored by the majority of the Tax Court, although discussed by the minority. This point is directly presented and fully covered in the *Adams* case, which is to be argued at the same time as the case at bar, hence we do not deem it necessary to discuss it at length.

II. IF THE EXCHANGE IS NOT VIEWED AS A REORGANIZATION NON-TAXABLE UNDER SECTION 112 (b) (3), IT IS NEVERTHELESS AN EXCHANGE UNDER SECTION 112 AND BY SECTION 112 (b) (2) AND SECTION 112 (c) (1) IS TAXABLE UNDER SECTION 117.

Petitioner Did Not and Will Not, by Means of the Recapitalization, Escape Any Tax to Which, But for It, He Would Have Been Subjected.

In the Tax Court's opinion it was intimated (see R. p. 102a) that the individual stockholders may have had it in mind so to arrange that on redemption of the bonds they would be taxable on their proceeds only at the capital gains rate.

Admittedly there was no tax liability impending against either the corporation or its shareholders at the time the Plan of Reorganization was planned, adopted, or put into effect.

This Court has frequently emphasized the right of a taxpayer properly to minimize his taxes.[8]

If the stockholders had merely desired to realize $400,000, at the same time retaining their common stock, but be liable for tax on that amount only at the capital gains rate, there were several other ways that they could have accomplished this.

They could have had declared a stock dividend of $400,000 payable to the common stockholders in preferred stock and subsequently sold the preferred stock. There would have been no tax on account of the stock dividend[9] and on the sale of the preferred stock they would have been liable to tax only at the capital gains rate.

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(8) *Gregory v. Helvering*, 293 U. S. 469: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *United States v. Isham*, 17 Wall. 496, 506, 21 L. Ed. 728."

(9) *Commissioner v. Sprouse*, 318 U. S. 604.

Similarly, they could have liquidated the company, in which case they would have paid capital gains tax on the difference between their investment basis and their realization from the liquidation. Afterward they could have formed a new company and turned over to it the entire assets realized from the liquidation in exchange for 500,000 shares of no par stock, and $400,000 bonds, in which case they would have been liable for no further tax on the redemption or payment of the bonds at maturity.

The stockholders have not evaded or avoided any tax liability to which they were subject. As said by the Court below in *Commissioner v. Gilmore*, 130 F. (2d) 791 at page 795, the law does not require a taxpayer to avail himself of the method of attaining a given result which will subject him to the most taxes.

The Court Below Disregarded the Essential Primary Finding by the Tax Court That the Transaction Was a Unitary Exchange of Old Stock for New Stock and Bonds.

Assuming, for the purpose of the present argument, that the recapitalization was not tax free because not demonstrably for the benefit of the corporation, the Tax Court had squarely presented to it the problem of deciding, as a matter of fact, whether the transaction was

(1) a single transaction,—a unitary exchange of the 1,000 old $100 par shares for 5,000 new no par shares *and* $400,000 debenture bonds; or,

(2) an exchange of the old stock for the new stock, *followed by* a distribution of the bonds as a dividend.

This Court said, in *Dobson v. Commissioner*, 320 U. S. 489 at page 502:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary

determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact."

It was accordingly incumbent on the Tax Court to find specifically whether this was an *exchange* of the old common stock for the new common stock *and* the debenture bonds, or to find, as it did in *Edith B. Bass*, 45 B. T. A. 1117, 1120-21 (see also 129 F. (2d) 300) that the delivery of the bonds was an independent distribution and not part of the unitary exchange.

The Tax Court found that the transaction in question was an **exchange** of the old common stock for the new common stock **and** the debenture bonds.[11] In describing the plan of reorganization, it said:

> "The corporation was to issue **in exchange for the old stock**, the new stock **and** the debenture bonds . . ." (R. pp. 92a-93a.)
>
> "**Pursuant to the plan**, the stockholders on March 16, 1939, delivered their 1,000 shares of common stock to the corporation and received from the corporation the 5,000 shares of its new common stock and debenture bonds in the aggregate principal amount of $400,000." (R. 93a-94a.) (Emphasis supplied.)

At the end of the first paragraph of its opinion the Tax Court again characterizes the transaction as "**an exchange of stock for stock and securities** of the same corporation" (R. p. 96a.)

The Tax Court at the beginning of its formal Findings of Fact (R. 90a), found the facts in the stipulation including paragraphs 10, 12 and 18, which (R. 16a-18a) stated that

(11) In *Flanagan v. Helvering*, 116 F. (2d) 937, cited by the Court below, there was admittedly a redemption of part of the corporation's stock, which the Tax Court held not to have been a partial liquidation but essentially equivalent to the distribution of a taxable dividend taxable as such under Sec. 115 (g).

the shares of new common stock and the debenture bonds were issued by the company **in exchange** for the shares of $100 par stock previously outstanding.

Under the record admissions and allegations by the Commissioner in this case, the Tax Court could not have found otherwise.

In his income tax return for 1939 petitioner had returned no gain from the receipt of the new stock and bonds in the recapitalization; taking the position that, under Section 112 (b) (3) and 112 (g) of the Act, no gain or loss was properly recognizable therefrom.

The Commissioner, however, increased petitioner's taxable income by $319,200, explaining such increase in the deficiency notice (R. 17a) as follows:

> "'(a) Other income has been increased $319,200 representing the fair market value of bonds of J. Robert Bazley, Inc., **received in exchange of common stock of that corporation.**'" (Emphasis supplied.)

In his petition to the Tax Court contesting the additional assessment based on the above, petitioner alleged, under paragraph V (5) and (6) (R. pp. 5a-6a):

> "(5) **Pursuant to the Plan** of Reorganization and Recapitalization, **the corporation exchanged** the 5000 shares of new common stock without par value **and** $400,000. of principal amount of debenture bonds for the 1000 shares of common stock outstanding. **The exchange** was made on the basis of 5 shares of new common stock without par value **and** $400. of debenture bonds for each share of old common stock outstanding. The 1000 shares of old common stock were then cancelled on the books of the corporation.
>
> "(6) The Petitioner in April, 1939, **pursuant to and in accordance with the terms of the Plan** of Reorganization and Recapitalization **received in exchange** for his 798 shares of $100. par value common stock of

J. Robert Bazley, Inc., 3990 shares of no par value common stock and $319,200. principal amount of 20 year 6% debenture bonds of the same corporation. • • •

• • • • • • •

"In the further alternative, if it be held that Petitioner realized taxable income or gain in 1939 as a result of the foregoing exchange, then Petitioner contends that the Commissioner erred in determining that such income or gain was ordinary income instead of capital gain as provided by Section 117 of the Internal Revenue Code." (Emphasis supplied.)

In the Commissioner's answer to the above paragraphs of the petition, he alleged:

"(5) Admits that said corporation **exchanged** 5,000 shares of new common stock without par value **and** $400,000.00 of principal amount of debenture bonds for the 1,000 shares of old common stock outstanding; admits that the **exchange** was made on the basis of 5 shares of new common stock without par value **and** $400.00 of debenture bonds for each share of old common stock; admits that the 1,000 shares of old common stock were then cancelled; denies the remaining allegations of paragraph V (5) of the petition.

"(6) Admits that in April, 1939, petitioner **received in exchange** for his 798 shares of $100.00 par value old common stock of J. Robert Bazley, Inc., 3,990 shares of no par new common stock of said corporation **and** $319,200.00 principal amount of 20-year 6% debenture bonds of said corporation; denies the remaining allegations of the first sentence of paragraph V (6) of the petition; • • • denies the remaining allegations and opposes the remaining contentions made by petitioner in said paragraph V (6) of the petition." (R. pp. 12a-13a.) (Emphasis supplied.)

If the Tax Court, disregarding the stipulation and respondent's admissions, had found that the transaction **did not in fact** consist of an exchange of the old stock for new stock **and** bonds, but in fact consisted of an exchange of the old stock for the new stock, and that the "distribution" of the bonds was in fact a separate transaction and not part of the exchange, this would be a different case. The Tax Court, however, did not so find, but found that the issuance of the bonds was part of the unitary transaction which constituted the exchange.

In disregard of this Court's admonition in the *Dobson* Case, and in spite of the express admissions by the Commissioner on which were based the findings of the Tax Court above quoted, the majority of the Court below, as clearly shown by the last paragraph of its original opinion (R. p. 116), treated the transaction as one involving an exchange of the old stock for the new stock "followed by a distribution of the 20 year debenture bonds."

Under the rule of *Dobson v. Commissioner*, it is not the function of the Circuit Courts to alter the primary findings of fact by the Tax Court in order to sustain its legal conclusions, any more than to reverse them.

Under *Bingham's Trust v. Commissioner*, 325 U. S. 365, it is both the function and duty of the Federal Appellate Courts to correct the Tax Court's erroneous application of the law **to the facts found by that Court.**

Under the finding by the Tax Court that this was a unitary exchange, we have the simple case of an exchange of property, the old stock, which had been held by the taxpayer for 9 years, for new stock **and** bonds.

In the Tax Court's opinion it is stated (R. p. 96a) that "*since there was an exchange* of stock for stock and securities in the same corporation, the language of the section forbids recognition of gain or loss." (Emphasis supplied.)

In view of the foregoing how can it now be contended that, irrespective of whether or not the transaction was a tax free reorganization, the issue of the bonds, together

with stock, was not in *exchange* for the stock but was "essentially equivalent to the distribution of a taxable dividend" *on the stock* under Section 115 (g)?

Admittedly the old stock was not "redeemed" by the corporation. It was doubtless for this reason,—recognizing that Section 115 (g) was not designed to cover and does not cover cases involving a recapitalization of a corporation's entire capital structure in a reorganization,—that the Commissioner, in his brief in the Court below (p. 30) repudiated the Tax Court's legal conclusion that this case came under subdivision (g) of that Section, and relied on subdivision (a) of that Section, despite the Commissioner's admission and Tax Court's express finding that the debenture bonds were issued with the new stock, in exchange for the old stock.

There being a unitary exchange of old common stock for new common stock and debentures—all the cases are clear that the transaction may not be broken into one exchange plus a distribution, or into two exchanges.

Dobson v. Commissioner, 320 U. S. 489, 502;
Helvering v. Minnesota Tea Co., 89 F. (2d) 711 (1937); affd. 302 U. S. 609;
Starr v. Commissioner, 82 F. (2d) 964 (1936); cert. den. 298 U. S. 680;
Ahles Realty Corp. v. Commissioner, 71 F. (2d) 150 (1934); cert. den. 293 U. S. 611;
Prairie Oil & Gas Co. v. Motter, 66 F. (2d) 309 (1933);
Shenandoa Rayon Corp. v. Commissioner, 122 F. (2d) 268 (cert. den. 314 U. S. 696);
South Atlantic S. S. Co. v. Commissioner, 42 B. T. A. 705;
Globe-News Co. v. Commissioner, 3 T. C. 1199;
Clayton and Hooks v. Commissioner, Memo. Dec. Docket Nos. 109416, 109427, entered August 22, 1944, C. C. H. Dec. #14111 (M).

In view of the apparent misunderstanding by the Court below, not only of the Tax Court's findings of fact, but of the scope of these complex provisions of the statute, a brief further analysis of the provisions of the law relative to the sale and exchange of property will, we believe, be helpful to the Court.

Upon *every sale of property* for cash *and upon every exchange of property for other property*, the Code, by Sec. 111,[12] first requires that there shall be made *a determination* of the total amount of the gain or loss therefrom; irrespective of the extent to which such gain may or may not be taxable. This is also true regardless of the fact that the exchange is or is not in connection with a "reorganization", as such term is used in Sec. 112. Sec. 111 therefore prescribes that in computing such gain or loss there shall be subtracted from the value of all property received the cost basis of the property given up in the exchange.

Accordingly, since in this **admitted exchange** the taxpayer exchanged his 798 shares of $100 par stock, having a cost basis of $79,800, for new no par common stock (3,990 shares) valued at $239,400. and new debenture bonds valued at $319,200, Sec. 111 (a) and (b) requires the gain to be computed as follows:

Value of new bonds	$319,200
Value of new stock	239,400
Total value realized from exchange	$558,600
Minus cost basis of $100 par stock	79,800
Total gain determined	$478,800

However, Sec. 111 (c) states *that the extent to which* **such gain** *shall be "recognized" for the purposes of income tax* must be determined by Sec. 112.

(12) See the various Sections of the Code hereafter referred to, as well as the Regulations in Addendum A hereto.

This latter section, by the general rule set forth in Sec. 112 (a), requires that the entire amount of such gain shall be recognized EXCEPT as further provided in the additional sub-divisions, Sec. 112 (b)-(g) inclusive.

The two *exceptions* to this general rule which, we submit, apply to the instant case (assuming the non-recognition of gain exception in (b) (3) not to apply) are Sec. 112 (b) (2) and Sec. 112 (c) (1).

The *first* applicable *exception*, namely, Sec. 112 (b) (2) prescribes that upon an exchange of common stock for common stock *no gain shall be recognized* and this exception is carried over into Sec. 112 (c) (1) which contains the *second exception.* This latter exception prescribes that where, upon such an exchange, there is received (in addition to common stock) other property, *then the gain so determined by Sec. 111* **shall be recognized** only in an amount which is not in excess of the fair market value of such "other property". This result is expressly and clearly borne out by the interpretative Treasury Regulations, Sec. 19.112 (b) (2)-1 and Sec. 19.112 (c)-1 (See Add. A pp. 44 and 46).

This latter Treasury Regulation (Sec. 19.112 (c)-1) specifically states that if *in any transaction* in which common stock is exchanged for common stock, *and not in connection with a corporate reorganization,* there is received by the taxpayer other property (in addition to property admitted to be received without recognition of gain) then the gain, if any, to the taxpayer will be recognized in an amount not in excess of the fair market value of the "other property".

Therefore, if this Court should hold that taxpayer's admitted "exchange" did not constitute a reorganization within the non-recognition gain exception of Sec. 112 (b) (3), it is quite clear that the *exceptions* of Sec. 112 (b) (2) and (c) (1) must be applied so that only that part of the gain is recognized which represents the value of the "other property", namely, the bonds (valued at $319,200) received in the exchange by taxpayer.

The next statutory step required is to ascertain the extent to which the "recognized gain", if any, shall be taken into account as capital net gain, and is to be found in Code Sec. 117 (b) which prescribes that where the capital asset has been held for more than 24 months then 50 percentum of such "recognized gain" shall be taken into account. Consequently, since Bazley, the taxpayer, held his old $100 par stock for more than 24 months, having acquired the same in May, 1930, Stip. par. 12, R. 17a, when the corporation was organized, only 50 percentum of the recognized gain upon the admitted "exchange" or $159,600. must be taken into account in computing his taxable capital gain.

The last statutory step is to ascertain the amount of tax to be imposed upon the taxable gain. This is prescribed by Sec. 117 (c) "Alternative Taxes".—(1) to the effect that the tax on such capital gain shall not exceed 30 percentum of that part of the gain to be taken into account or $47,880.

The Tax Court and the Court below held that this transaction did not constitute a reorganization within Section 112 (b) (3) because it lacked a legitimate corporate business purpose, but failed to realize that even assuming such purposes to have been lacking, nevertheless, it was an exchange under the express provisions of Section 111 and 112 because the courts say the transaction must be looked at as a whole.[13] Therefore, the transaction falls within Section 112 (b) (2) for the reason that there was an exchange of par value common for no par value common. However, as bonds were a part of the consideration given with the no par common the bonds, unlike "securities" under the provisions in a 112 (b) (3) reorganization, constitute "other property" and, therefore, come within Section 112 (c) (1) [14] which provides, in effect, that gain or

(13) See cases cited p. 20, *supra*.

(14) Section 112 (c) (1):

"(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

loss shall be recognized to the extent of the fair market value of such "other property."

Our dispute with the decision of the Tax Court is not a dispute over proper accounting, but a challenge of the correctness of that Court's conclusion of law that, despite its express finding that this was an exchange of stock for stock *and* bonds, pursuant to respondent's clear admission and agreement that such was the case, the Tax Court concludes *as a matter of law* that the issuance of the bonds was a dividend, separate from and prior or subsequent to the exchange, of which it had previously found that it was an integral part.

In *Commissioner v. Estate of Bedford*, 325 U. S. 283, decided May 21, 1945, the Court said that a transaction which was properly an exchange under Section 112 could not be taken out of the requirements of that Section and forced into the mould of Section 115. That case involved the exchange of stock for stock and cash under what the Court held was a reorganization and which accordingly came directly within Section 112 (c) (2) [15] and since the cash represented earnings after 1913 it was taxable under that section as a dividend and not, as the taxpayer contended, as a partial liquidation under Section 115.

In the case at bar the exchange comes under 112, but being, *by hypothesis, not a reorganization*, does not come under 112 (c) (2), which is confined to reorganizations, but comes under 112 (c) (1) which applies to cases in which a transaction would be under 112 **(b)** (2) but for the other property—an exchange for stock plus some property other than stock, i. e., the debentures.

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(15) Section 112 (c) (2):

"(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

Gains realized by the exchange of capital assets as determined under Section 111 and recognized under 112 (c) (1) are therefore taxed under Section 117 relating to gains in the exchange of capital assets.

Accordingly, the gain represented by the value of the bonds would be taxable at the capital gains rate.

CONCLUSION.

The question as to whether this Court's opinion in the *Gregory* case requires a recapitalization to be for the benefit of the corporation as distinguished from the stockholders is clearly a question of law in which the Tax Court's conclusion is reviewable on appeal.

The exchange of the old $100 par stock for new no par stock and debentures was a recapitalization of the Bazley Corporation, and since debentures are securities within the meaning of Section 112 (b) (3), the exchange comes precisely within the terms of that provision.

The transaction was in no sense a sham, but was a genuine recapitalization. This genuineness is in no way impaired by the fact that reasons which the Tax Court found as actuating the recapitalization were for the primary benefit of the stockholders, as distinguished from that of the corporation itself. Furthermore, the recapitalization was a benefit to the corporation in that it rendered the corporation's stock more readily marketable, and effected an annual tax saving to it by reason of the future deduction from income of the annual interest on the debentures.

The continuity of interest on the part of the stockholders was not to the slightest degree impaired by the recapitalization. After it the three stockholders remained in the ownership and control of the corporation in precisely the proportions which they did before.

Petitioner did not, by means of the recapitalization, escape any tax impending against him or any to which he should properly be subjected in the future. He could have received a stock dividend in preferred stock and have

sold it, or could have liquidated the company and received all its assets, subject to payment of capital gains tax on the gain realized thereby over the cost of his stock. If, when and as his debentures are sold or redeemed, he will pay capital gains tax on the gain represented by them.

If, by reason of the absence of a legitimate corporate business purpose, the transaction is not a reorganization under Section 112 (b) (3), it is certainly an exchange of stock for stock and "other property" (the debentures) under Section 112 (b) (2), in which case such "other property," being received in partial exchange for stock held for more than 24 months, is taxable under Sections 112 (c) (1) and 117. Under the decisions, the single transaction, being an exchange under Section 112, cannot be taken out of the requirements of that Section and forced into the mould of Section 115 (g) as a dividend. Accordingly, on the theory of the Tax Court that the exchange was not a reorganization, the gain represented by the value of the debentures would be taxable at the capital gains rate under Section 117.

It is respectfully submitted that the judgment of the Court below should be reversed and judgment entered for the petitioner.

Respectfully submitted,

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ADDENDUM A.

PERTINENT PROVISIONS OF THE INTERNAL REVENUE CODE AND THE TREASURY REGULATIONS.

(*Emphasis in bold-faced type supplied.*)

CHAPTER I. Income tax.

Subchapter B. General Provisions.

Part II. Computation of Net Income.

Subchapter C. Supplemental Provisions.

Supplement B. Computation of Net Income.

(Supplementary to Subchapter B, Part II).

CODE SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) **Computation of gain** or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) * * *.

(b) **Amount realized.**—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) **Recognition of gain** or loss.—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112. * * *

REGULATION SEC. 19.111-1. **Computation of gain or loss.**—Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property which is received. * * * The general method of computing such gain or loss is prescribed by section 111, which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 113 (b) * * *.

CODE SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) **General rule.**—Upon the sale or exchange of property the **entire** amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

REGULATION SEC. 19.112 (a)-1. **Sales or exchanges.** The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. **The general rule is that the entire amount of such gain or loss is to be recognized.**

An exception to the general rule is made by section 112 (b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the

Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. **The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure,** and the new property **are substantially continuations of the old still unliquidated.**

The Internal Revenue Code makes specific provision for the case in which, in addition to property which may be received tax free on the exchange, there is received as boot other property or money. In such a case gain is recognized to the extent of the boot (see section 112 (c) and (d), but no loss of any kind is recognized (see section 112 (e)).

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. **Nonrecognition is accorded by the** Internal Revenue **Code only if the exchange is one which satisfies both** (1) **the specific description in the Code of an excepted exchange, and** (2) **the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand.** The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112 (b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only. . . .

* * * * * *

CODE SEC. 112 (b). EXCHANGES SOLELY IN KIND.

(2) Stock for Stock of Same Corporation.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

REGULATION SEC. 19.112 (b) (2)-1. **Stock for stock of the same corporation.**—The exchange, without the recognition of gain or loss, of common stock for common stock, * * * in the same corporation is not limited to a transaction between a stockholder and the corporation; it includes an exchange between two individual stockholders. * * *

* * * * * * *

CODE SEC. 112 (b) (3). Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

CODE SEC. 112 (g). DEFINITION OF REORGANIZATION.—As used in this section and section 113.

"(1) the term 'reorganization' means * * * (E) a recapitalization," * * *

REGULATION SEC. 19.112 (g)-1. **Purpose and scope of exception of reorganization exchanges.**—Purpose: Under the general rule upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifica-

tions of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

Scope: The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 112 (b) (3) in which stock or securities in a corporation a party to the reorganization are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation a party to the same reorganization; and the exchange that is provided for in section 112 (b) (4) in which a corporation a party to the reorganization exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation a party to the same reorganization. Section 112 (g) limits the definition of the term "reorganization" to six kinds of transactions and excludes all others. From its context, the term "a party to a reorganization" can only mean a party to a transaction specifically defined as a reorganization by section 112 (g). Certain rules respecting boot received in either of the two types of exchanges provided for in section 112 (b) (3) and (4) are prescribed in sections 112 (c) and 112 (d). Under section 112 (i) a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope.

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

REGULATION SEC. 19.112 (g)-2. **Definition of terms.**—The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112 (g) (1). * * *

A "recapitalization," and therefore a reorganization, takes place if, for example—

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) **A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or**

(4) An exchange is made of a corporation's outstanding preferred stock, having certain prior-

ities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interest under modified corporate forms.

As used in section 112, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction "or" denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if "stock and securities" are received in exchange as well as if "stock or securities" are received.

REGULATION SEC. 19.112 (g)-3. **Exchanges solely of stock or securities, or property, solely for**

stock or securities, in pursuance of plan of reorganization.—No taxable income is received, nor is a deductible loss sustained, if the shareholders in a corporation a party to the following reorganization transactions exchange stock or securities solely for stock or securities of the same corporation, or of another corporation mentioned, * * *:

(6) The exchange of stock or securities solely for stock or securities of the same corporation in the case of (a) a recapitalization of a corporation, or (b) a mere change in the identity, form, or place of organization of a corporation, however effected.

REGULATION SEC. 19.112 (g)-4. **Exchanges in reorganization for stock or securities and other property or money.** If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)). * * *

If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an

amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized. * * *

CODE SEC. 112 (c). GAIN FROM EXCHANGES NOT SOLELY IN KIND.

(1) If an exchange would be within the provisions of subsection (b) * * * (2) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, **to the recipient shall be recognized,** but **in an amount not in excess** of the sum of such money and the **fair market value of such other property.**

(2) If a distribution made in **pursuance of a plan of reorganization** is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

REGULATION SEC. 19.112 (c)-1. **Receipt of other property or money in tax-free exchange** *not connected with* **corporate reorganization.**—If in any transaction in which * * * (b) common stock is exchanged for common stock, * * * in the same cor-

poration **and not in connection with a corporate reorganization;** * * * there is received by the taxpayer other property (in addition to property permitted to be received without recognition of gain) or money, **then**

(1) **The gain, if any, to the taxpayer will be recognized in an amount not in excess** of the sum of the money and **the fair market value of the other property,** but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (e)). * * *

See section 113 (a) (6) for the basis for determining the gain or loss from the subsequent sale of the property received in exchanges such as described in this section.

As to the receipt of other property or money on an exchange of stock or securities in connection with a reorganization, and as to distributions in pursuance of a plan of reorganization which have the effect of a taxable dividend, see section 19.112 (g)-4.

CODE SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) Definition of dividend.—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(c) Distributions in liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. * * *

(g) Redemption of stock.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

REGULATION SEC. 19.115-9. **Distribution in redemption or cancellation of stock taxable as a dividend.**—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

* * * * * *

(h) Effect on earnings and profits of distributions of stock.—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or an behalf of a corporation of its

stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act. * * *

REGULATION SEC. 19.115-11. **Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.**—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b), that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1) * * * or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution. * * *

CODE SEC. 117. CAPITAL GAINS AND LOSSES.

(b) Percentage taken into account.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset

shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 2/3 per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

REGULATION SEC. 19.117-2. **Percentage of capital gain or loss taken into account: Net loss carry-over.**—(a) General.—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117 (b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held.

CODE SEC. 117 (c). ALTERNATIVE TAXES.

(1) In case of net long-term capital gain.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain. * * *

ADDENDUM B.

Analysis of Decisions by the Tax Court Subsequent to Gregory, and Sustaining Recapitalizations Which Were Primarily or Exclusively for the Benefit of the Stockholders.

Apparently the first case in which the Board was asked to apply the *Gregory* principle to a recapitalization, as distinguished from a corporate reorganization in connection with the sale or distribution of corporate assets, was *L. & E. Stirn, Inc.*, 39 B. T. A. 143 (January 19, 1939). Here the transaction consisted of the exchange by a stockholder who owned 4636 shares of preferred stock, constituting 55.08% of the outstanding preferred, for $463,600 debentures. There was apparently no evidence whatever as to the reason or motives for the recapitalization, nor any suggestion of any benefit to the corporation resulting therefrom, the sole benefit being clearly that to the stockholder, except that corporate taxes obviously would be reduced by the deduction of the bond interest. Despite this, the Board sustained the recapitalization as within the Act, saying (p. 146):

> "Here it [petitioner] cites *Gregory v. Helvering*, 293 U. S. 465, but we are unable to see the applicability of the situation. The transaction comes precisely within the terms of the statute *and there is no suggestion that the transaction was not entered into for a business purpose.*" (Emphasis supplied.)

Chester A. Souther, 39 B. T. A. 197 (January 25, 1939) was a case involving very elaborate facts, the gist of which was that General Motors Securities and Managers Securities Co. were reorganized in order that certain officers and employees of General Motors, who wished to continue in a profit sharing arrangement could so continue, and the

others who did not wish to continue could get General Motors stock. There was no possible corporate benefit or corporate purpose of the reorganized corporation in connection with the reorganization, which was undertaken and carried through solely for the stockholders' benefit. The reorganization was approved by the Board because it was a genuine transaction, not undertaken solely to avoid tax. In so approving it, the Board said (p. 216):

> "* * * It is thus apparent that the plan devised and executed was prompted *not only by a motive of tax avoidance*, but for the purpose of providing a means whereby those stockholders who preferred to maintain their investments in a holding company might do so, while others might liquidate and acquire the direct ownership of General Motors common stock if they so desired. In this connection it is noted that more than two million of the class A shares were still outstanding on December 31, 1935. Certainly on these facts it can not be said, as it was in Gregory v. Helvering, supra, that 'the whole undertaking * * * was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else.' * * *
>
> "It is, of course, true that the organization and maintenance of a pure holding company do not ordinarily serve a business purpose comparable to the purposes of commercial, industrial, trading, or financial organizations and similarly a difference in business purpose exists in the reorganization of a holding company. But where the purposes which prompt the organization of a holding company in the first instance are inherent in the reorganization of such company and the plan followed is within the wording of the statute, there is, in our opinion, no basis or ground for applying the doctrine of Gregory v. Helvering, supra, to such a reorganization and to hold, as the petitioners here contend, *that it was solely a device to avoid tax.*" (Emphasis supplied.)

A similar case was *Elmer W. Hartzell*, 40 B. T. A. 492 (August 23, 1939), the facts of which are substantially those in the hypothetical case suggested by Judges Goodrich and Maris at the end of their dissenting opinion in the Court below (R. p. 140). Although it does not mention *Gregory* or the *Gregory* principle, the decision involved the applicability of the *Gregory* test. This case involved the question as to whether gain was realized in the exchange, by a group of younger stockholders with another group of the older stockholders, of common stock for preferred through a recapitalization. The general purpose of the recapitalization and of the exchange which the Board held to be a part of the reorganization (although the dissenters thought it was not, but a subsequent and independent step) was in order that the younger stockholders might end up with all the common stock and the older stockholders end up with preferred stock, both having started out with common. There was no conceivable corporate purpose or corporate benefit, unless it would be to have younger stockholders in control. The transaction was purely a shuffling of the control amongst the stockholders, effected by a bona fide recapitalization not undertaken for tax avoidance. The Board held that no gain had been realized.

In *C. A. Munroe*, 39 B. T. A. 685 (April 5, 1939) the Board, discussing the *Gregory* doctrine, said:

> "it is not necessary that the business purpose of every corporation shall be strictly commercial," or that the reorganization, in order to be tax-free, must be profitable, provided the reorganization is a genuine one and not a sham.

In *J. D. and A. B. Spreckels Co.*, 41 B. T. A. 370 (February 14, 1940), the Board extended the *Gregory* principle by analogy, holding that where one corporation acquired all of the stock of another corporation which had a large loss and had ceased doing business, in order to include this loss in the acquiring corporation's consolidated return, this

could not be done where the only purpose of acquiring the stock was to reduce its tax.

Again, in *Ardbern Co. Ltd.*, 41 B. T. A. 910 (April 23, 1940) the Board held ineffective the organization of a Newfoundland corporation which participated in a reorganization for the purpose of eliminating taxes.

In *Peck and Peck*, 42 B. T. A. 651 (August 29, 1940) the Board sustained a recapitalization against the contention of the Commissioner that the *Gregory* case was applicable, although the only conceivable purpose and effect of the reorganization was to benefit the stockholders and no benefit to the corporation was pointed out.

In *Lyon, Inc.*, 42 B. T. A. 1094 (October 29, 1940) the Commissioner contended and the Board held that in a conduit corporation case like *Gregory* the Commissioner could, if he wished, elect to treat the case as involving a tax-free reorganization. On appeal, however, the Circuit Court of Appeals for the 6th Circuit (127 F. (2d) 210, April 13, 1942) said that the Commissioner had no right so to elect and that if the *Gregory* case was properly applicable, it must be applied.

In *Anna V. Gilmore*, 44 B. T. A. 881 (July 3, 1941), the Board held, in a case subsequently affirmed by the Circuit Court of Appeals for the Third Circuit, (130 F. (2d) 791) that a merger of a holding company with a subsidiary constituted a tax-free reorganization, although the parent corporation held but a bare majority of the stock of the subsidiary which merged with it; this, despite the dissent by Judges Turner and Hill on the ground that the *Gregory* case was applicable and that the transaction really constituted a liquidation. A similar later decision is that in *George Palen Snow*, Docket No. 107,390 Memo. Decision, December 10, 1942 (CCH Decision No. 12,908 (M)).

In *Isaac W. Frank Trust of 1927*, 44 B. T. A. 934 (July 9, 1941) the Board held, despite the Commissioner's argument as to the applicability of the *Gregory* case, that the partnership there involved had been formed, not merely

to avoid taxes, but also for a business purpose, to relieve certain trustees of the possibility of surcharge. Judge Mellott dissented on the ground that under the rationale of the *Gregory* case the partnership should be disregarded.

In *Edith B. Bass*, 45 B. T. A. 1117 (December 30, 1941) a corporation had outstanding 600,000 shares of common stock without par value and with a stated value of $6,000,000, all held in a voting trust. In order to provide more marketable shares and thus satisfy the stockholders, and to provide additional marketable shares which the corporation might sell, a plan was devised and authorized by which the capital was increased from 600,000 shares, without par value, to 50,000 shares of $100 par value preferred stock and 600,000 shares of no par value common stock. 300,000 shares of common with a stated value of $3,000,000 were exchanged for 30,000 shares of the new preferred stock of par $3,000,000 and the remaining 300,000 shares of common stock were increased to 600,000 shares. The effect of this obviously was to put the 30,000 shares of preferred stock in the hands of the same stockholders who ended up with exactly the same amount of common stock with which they began and the preferred stock in addition. The Board held that the transaction was in essence a dividend of the preferred stock, since the stockholders ended up with exactly the same amount of common stock with which they began. The case was reversed, however, on appeal (129 F. (2d) 300) on the ground that no surplus was recapitalized. The Board did not rely on the distinction between a corporate and a stockholder's purpose, or even mention this possible distinction.

Jacob Fischer, 46 B. T. A. 999 (April 28, 1942) did not refer to the *Gregory* doctrine but involved a set of facts where 7,000 shares of common of $100 par value, total $700,000, were converted into 35,000 shares of common with par $10, $350,000, and 14,000 shares of new preferred, par $25, $350,000, a total of $700,000. One, Henry Fischer, had owned over 52% of the outstanding stock and on his death

it was desired to guard against the change in management by a sale of the estate's stock. The Board of Tax Appeals relied on the fact that the transaction resulted in a wider distribution of the company's stock, the number of its stockholders having been increased from 11 to 300, but from a reference to the facts it appears that this distribution was effected, not by a sale of stock by the corporation, but by the stockholders. The Commissioner contended that the preferred stock was issued as a dividend, but the Board refused to support this contention, holding that there was a business purpose in the recapitalization in effecting a wider distribution of the stock, to secure a ready market, with an assurance against the change of control. It is noteworthy that the Board, in holding that the recapitalization was *bona fide* and not lacking in any business purpose, did not use the phrase *corporate* business purpose.

It is impossible to conclude, as a matter of fact, that it benefits a corporation to have the holder of a large block of its stock sell this to two or three hundred different holders. True, this may possibly benefit the corporation in some cases and, on the other hand, it may be more to its advantage to have one large stockholder than two or three hundred small ones. The decision, as well as the other similar decisions, merely emphasizes the unsoundness and the lack of practical common sense inherent in the Tax Court's new theory.

Clarence J. Schoo, 47 B. T. A. 459, (August 5, 1942) was a recapitalization case in which outstanding preferred and no par common stock were exchanged for new par value common and 25 year debenture bonds. The only conceivable purpose benefiting the corporation was in making available to the corporation unissued 5% preferred stock instead of 7%, which the president suggested would be more valuable for the payment of dividends on the common, and in the possible deduction of the interest on the debentures in assessing taxes. The Board held that it was a tax-free reorganization, saying (p. 462):

"There is nothing in the circumstances to invite the doctrine of *Gregory v. Helvering*, 293 U. S. 465. *No transaction was impending which threatened a tax on any of the participants. The recapitalization is not a sham or an artificial detour around a taxable event.* There is nothing to indicate that a devious form of corporate maneuvering was masquerading as a recapitalization in order to avoid a tax which would have been assessed if the transaction had been permitted to take its direct course." (Emphasis supplied.)

There was no statement, even in this late case, as to the necessity of a *corporate* business purpose as distinguished from a *stockholders'* purpose.

Edgar M. Docherty, 47 B. T. A. 462, (August 5, 1942) was also a case involving a recapitalization, the company being a small one of which the three officers owned all but 20 shares of the stock. The recapitalization consisted in the change of capital stock to 500 shares of no par value and the issue of $75,000 5% 20 year debenture certificates, subordinated to the claims of other creditors. There was suggested no conceivable *corporate* purpose, the sole benefit being to the three *stockholders*. The Board of Tax Appeals refused to sustain the Commissioner's contention that the *Gregory* case was applicable, saying: "the recapitalization was a bona fide readjustment of the corporation's financial structure for a legitimate business purpose."

It will be noted that the Board did not say for a legitimate *corporate* purpose, its expression "for a legitimate business purpose", obviously meaning "not undertaken solely for tax avoidance."

In *Capento Securities Corp.*, 47 B. T. A. 691 (September 22, 1942) there was also involved a recapitalization which the Board sustained and which was, in turn, sustained by the Circuit Court of Appeals, (140 F. (2d) 382) on the ground that the Board was *unable to find* that the

procedure adopted was without justifiable business foundation. The Board said (p. 694):

> "It is hard to see an actual realization of gain which is escaping tax by a factitious device, like that attempted in the *Gregory* case."

Here, it will be noted, both that the Board does not assert the necessity of a *corporate* business purpose and that it apparently treats the recapitalization as valid unless it *affirmatively* appears that it was *not* undertaken for a legitimate business purpose (i. e., a purpose other than tax avoidance).

The latest decision by the Tax Court, prior to Judge Harron's invention of the corporate business purpose theory, is *Annis Furs, Inc.*, Docket No. 110,894, (January 28, 1943) (CCH Decision No. 12945 (M)), the same recapitalization coming before the Court in *Annis Furs, Inc.*, 2 T. C. 1096 (November 30, 1943).

In the first case the question was as to the disallowance of a deduction claimed by the corporation for the interest paid on its 6% 20 year gold debentures, which it had issued in a recapitalization in exchange for 6½% preferred stock. The Commissioner disallowed the deduction on the ground that there was no business purpose justifying the recapitalization. The taxpayer testified and contended that the holders of the preferred stock wanted a permanent income, if possible, and the Commissioner contended that this was a reason personal to the stockholders and not a corporate purpose. Judge Black declined to make a finding as to what purpose actuated the exchange, but went on to say:

> "*If a corporation and its preferred stockholders for reasons satisfactory to themselves* agree upon an exchange of preferred stock for debenture bonds, then it seems to us that such is business purpose enough and we need look no further, provided of course that the obligation created by the bonds is genuine."

Subsequently, the case came up on the question as to whether the recapitalization constituted a tax-free reorganization. In holding that it did, the Tax Court said (p. 1098):

> "It can not be said, however, that this recapitalization served no reasonable or legitimate business purpose, for the reduction of the corporation's periodic charge from 6½ percent, as the dividend was under the preferred shares, to 6 percent, as the interest became under the debentures, *was a sufficient financial advantage to explain and justify the change.* This Court said as much (although not definitively) in a memorandum opinion (appeal dismissed C. C. A., 6th Cir., October 9, 1943) relating to the petitioner's own 1940 income tax and its right to deduct the debenture interest. The statement by petitioner's president that from the standpoint of the shareholders the exchange may have satisfied their desire for 'a permanent income if possible' does not detract from the *reasonableness as a purpose of the corporation's reduction of its interest charge.* We therefore hold that the exchange occurred in a reorganization, as defined in section 112 (g) (1) (E) of the Statute; and that, by section 112 (b) (3), no gain may be recognized. The exchange was not a distribution of earnings and profits but was a recapitalization thereof." (Emphasis supplied.)

Here, it will be noted that the change was a substitution of a fixed interest charge on 6% bonds for 6½% preferred dividend charges, which would be payable only out of profits.

In *The Humko Co.*, Docket No. 112235, 79, Decided December 11, 1943 (CCH Memorandum Decision No. 13,642 (M)), Judge Harron of the Tax Court disallowed a claimed deduction for interest on alleged loans made by two stockholders, which loans were subordinated to creditors, Judge Harron holding that this was a sham and that these were

not real loans. She pointed out that the transaction served no business purpose to the petitioner, which purported to borrow from its two stockholders at the rate of 6% when it could borrow from the bank at 3%, and held that the arrangement was unreal on its face. She then said:

> "Kopald testified that the arrangement was for the purpose of giving each stockholder some independent means outside of their proprietary interests in petitioner as evidenced by stock ownership. If that was the purpose, it does not aid petitioner. *It has been said frequently* that arrangements to suit the personal convenience of stockholders cannot be held to relate to the business and business purposes of a corporation, *where no business purpose to the corporation is served.*
>
> "The real question is whether or not there was any substance to the entire transaction. The evidence shows abundantly that there was not." (Emphasis supplied.)

As heretofore stated, this statement constituted, it is believed, the birth of the corporate business purpose doctrine. Judge Harron referred to no decision in support of her statement that "it has been said frequently", and none has been found.

Louis Wellhouse, Jr., 3 T. C. 363 (February 28, 1944) was the first recapitalization case in which the Court held that corporate business purpose, as distinguished from stockholders', was essential, and that no corporate business purpose was there present. In that case, preferred stock had been issued in exchange for common stock, in order that the petitioners might pay their private debts. The Tax Court held that the real purpose was to permit the stockholders to pay off their debts, and that it was immaterial that in so doing this it was desired to retain the control of the corporation in the petitioners. The Court pointed out that the sale of the stock necessary to pay the stock-

holder's indebtedness would not have deprived petitioners of control, and

> "The record fails to establish any need in the corporation itself, as distinguished from the petitioners-stockholders for funds at the time of the change in corporate structure."

This case, however, was decided for the taxpayer on other grounds.

Arthur J. Hooks et al., Docket No. 109416, 27—decided August 22, 1944 (CCH Decision No. 14,111 (M)), involved an elaborate recapitalization, the retirement of two classes of preferred shares on which there were arrears of dividends and the issue of debentures in exchange for the preferred. Judge Leach, of the Tax Court, in upholding the recapitalization found that there were seven different business purposes, a number of which were clearly in the interest only of the stockholders and not of the corporation.

The foregoing constitute all the pertinent decisions by the Tax Court which we have found, prior to the adoption by a majority of the Tax Court of the corporate business purpose test in the case at bar, as well as in the *Adams* case (4 T. C. 1186, April 26, 1943; 5 T. C. No. 40, June 29, 1945) and in *Marion Heady*, Docket Nos. 5812 and 5813, decided July 24, 1945, (CCH Decision No. 14,702 (M)).

It thus clearly appears that the corporate business purpose test was invented by the Tax Court as a construction of the *Gregory* decision, almost nine years after the rendering of the latter, and despite numerous decisions by the Board of Tax Appeals and by the Tax Court in the interim, wholly inconsistent with that test. Furthermore, from an examination of these cases, it is clear that the distinction between the benefit to the corporation and the benefit to the stockholders from a recapitalization is a wholly impractical and, in most cases, an imaginary one. A corporation is, in reality, the stockholders, conducting business in a specified statutory form. The only reason or excuse

for the existence of a corporation is to further the interest of the stockholders. In reality, whatever is in the interest of one is in the interest of the other. While theoretically there might be a distinction between the *motive* of the corporation and the *motive* of the stockholders, once we eliminate motive, as the Court below did in the *Gilmore* case (see note 8 of the original opinion of the Court below, R. p. 111) the distinction becomes wholly impractical and unworkable.

There have been many cases in which the sole or primary objective in a recapitalization has been the elimination of the accumulated and unpaid dividends on preferred stock. See for example:

Okonite Co., 4 T. C. 618 (January 29, 1945); affirmed 155 Fed. (2) 248 (April 18, 1946); cert. den. October 28, 1946;

Globe-News Publishing Co., 3 T. C. 1199 (August 4, 1944);

Knapp Monarch Co., 1 T. C. 59 (November 18, 1942), affirmed 139 F. (2d) 863 (C. C. A. 8th, January 17, 1944);

Elizabeth Morainville, 46 B. T. A. 753 (January 26, 1942), reversed 135 F. (2d) 201 (C. C. A. 6th, April 7, 1943);

Skenandoa Rayon Corporation, 42 B. T. A. 1287 (November 26, 1940), affirmed 122 F. (2d) 268 (C. C. A. 2nd July 31, 1941), cert. den. 314 U. S. 696 (December 22, 1941);

South Atlantic Steamship Line, 42 B. T. A. 705 (September 20, 1940);

Lelia S. Kirby, 35 B. T. A. 578 (March 9, 1937), affirmed on this issue 102 F. (2d) 115 (C. C. A. 5th, March 8, 1939).

In none of these cases has it been contended that the doctrine of *Gregory v. Helvering* could apply despite the fact that the moving consideration is obviously to benefit the

common stockholders, the accrual of preferred dividends not being a liability to the corporation, but merely a deterrent from future common dividends. In fact in many of these cases the corporation, after the recapitalization, has bonds outstanding in the amount of the accrued dividends, and has reduced its net worth accordingly, which is consistent only with a stockholder as distinguished from a corporate benefit. See for example:

Globe-News Publishing Co., 3 T. C. 1199 (*supra*) (scrip payable in 25 years with interest at 4%);

South Atlantic Steamship Line, 42 B. T. A. 705 (*supra*) (25 year 5% debentures and scrip);

Lelia S. Kirby, 35 B. T. A. 578 (*supra*) (15 year 6% first mortgage gold bonds).

IN THE

Supreme Court of the United States

No. 287.

October Term, 1946.

J. ROBERT BAZLEY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

REPLY BRIEF FOR PETITIONER.

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TABLE OF CASES CITED.

	Page
Adams, 4 T. C. 1186; 5 T. C. 351	6
Bedford, Estate of, Commissioner v., 325 U. S. 283	7
Dobson v. Commissioner, 320 U. S. 489	2
Gregory v. Helvering, 293 U. S. 465	1, 2, 3, 5, 6

STATUTES CITED.

(All Printed in Addendum A to Brief, pp. 37-52.)

	Page
Internal Revenue Code, 53 Stat. (Part I); 26 U. S. C. A.:	
Sec. 112 (b) (3), 53 Stat. 37	7
Sec. 112 (c) (1), 53 Stat. 39	7
Sec. 112 (c) (2), 53 Stat. 39	6, 7
Sec. 115 (a), 53 Stat. 46	6, 7
Sec. 115 (g), 53 Stat. 48	6, 7
Sec. 117, 53 Stat. 50	7

TREASURY REGULATIONS CITED.

(All Printed in Addendum A to Brief, pp. 37-52.)

	Page
Reg. 86:	
Art. 112 (g)-1	1
Art. 112 (g)-2	1
Reg. 103:	
Sec. 19.112 (a)-1	3, 5
Sec. 19.112 (g)-1	1, 3, 4
Sec. 19.112 (g)-2	1, 4, 5

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REPLY BRIEF ON BEHALF OF PETITIONER.

In his present brief, the Commissioner has so shifted his position on the principal point in the case from that heretofore advanced by him, that a short reply brief is necessary.

Heretofore the main question has always been whether, as the Tax Court held, *Gregory v. Helvering*, 293 U. S. 465, decided that a corporate reorganization, in order to be tax free, must be one conducted for a "corporate business purpose" of the corporation as distinguished from serving a proper business purpose of the shareholders.

Realizing, perhaps, that there could be no more "clear-cut question of law," than that involving a construction by the Tax Court of this Court's decision, the Commissioner's present brief would have it appear that the question is not the correctness of the Tax Court's construction of the *Gregory* case, but is the validity of the Treasury Regulation [1] (adopted in 1934 to put into effect the *Gregory* decision by the Circuit Court of Appeals for the Second

(1) Articles 112 (g)-1 and 112 (g)-2 of Treasury Regulations 86, as embodied in Sections 19.112 (g)-1 and 19.112 (g)-2 of Treasury Regulations 103.

Circuit), two isolated clauses of which are now quoted and relied on by the Commissioner. He now contends that for this Court to reverse the Court below and the Tax Court would involve a holding that these Treasury Regulations were "invalid." The *Gregory* decision is now relied on, not as controlling this case but merely as presenting "a similar restriction upon the scope of the reorganization provisions by this Court" (Commissioner's brief, p. 14). *Dobson v. Commissioner*, 320 U. S. 489, is injected in support of a supposed finding by the Tax Court that the present recapitalization was not "undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization" as stated in the Regulation.

Although the Regulation was cited by the Commissioner in his brief in the Tax Court, that Court in its opinion made no reference whatever to the Regulation.

While in his brief in the Circuit Court of Appeals, the Commissioner cited the Regulation in support of the Tax Court's construction of the *Gregory* decision, the question there presented was as stated in Judge O'Connell's first opinion (Rec. 109-110):

> "The issue here is sharply defined: The Commissioner maintains that, absent a legitimate corporate business purpose, there can be no tax free reorganizational transaction, under the doctrine of Gregory v. Helvering, 293 U. S. 465 (1935). Petitioner, however, argues that the *Gregory* decision is inapplicable where there exists a legitimate business purpose of the *stockholders* for the reorganization ('Reasons other than tax avoidance', to use the petitioner's phrase)."

What the Tax Court found was that there "was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds" (Rec. 95a).

Obviously this finding is relevant only provided the Tax Court was right in its construction of the *Gregory*

decision in requiring a "legitimate purpose of the corporation's business," as distinguished from a purpose, other than tax avoidance, for the benefit of the stockholders.

As stated by the Commissioner on page 5 of his present brief "The reasons for the adoption of the plan" found by the Tax Court were the four specified, none of which was tax avoidance. The Commissioner on page 33 says:

> "We are not here contending that the plan of recapitalization should be disregarded, or that the securities issued in pursuance of it are unreal or not valid in accordance with their tenor."

Furthermore, the Regulations now relied on, from which the Commissioner and the Court below quote but two isolated phrases, do not, read as a whole, support the distinction between a corporate and a stockholder purpose.

As stated above, these Regulations were adopted to implement the *Gregory* decision. For the purposes of the present question, the significant portions are as follows:

> Sec. 19.112(a)-1 Sales or Exchanges.
>
> * * * The exchange must be *germane to*, and a necessary incident of, *the* **investment** *or enterprise in hand.*
>
> Sec. 19.112(g)-1. Purpose and scope of exception of reorganization exchanges.—*Purpose:* * * * The purpose of the reorganization provisions * * * is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, * * * as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were

the owners of the enterprise prior to the reorganization.

* * *

* * * Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

Sec. 19.112(g)-2. Definition of terms.—* * *

* * *

A "recapitalization," and therefore a reorganization, takes place if, for example—

* * *

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock; or

* * *

Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112(g)(1), *but the readjustments* involved in the exchanges effected in the consummation thereof *must be undertaken for reasons germane to the continuance* of the business of a corporation a party to the reorganization. Section 112(g)(1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms. (Emphasis supplied.)

These provisions obviously do not require that an exchange, in order to be tax free, shall be in furtherance of some *corporate* objective as distinguished from one for the primary benefit of the stockholders. Such a distinction between an advantage to the corporation and to the stock-

holders is not deducible therefrom, particularly in view of the passage at the beginning under Regulation Sec. 19.112(a)-1 providing that the exchange must be germane to the **investment or** enterprise in hand.

The Commissioner in his present brief significantly omits all reference to illustration (3) in Sec. 19.112(g)-2 of the Regulations, above quoted, in which it is specifically stated that a tax-free "recapitalization" takes place when a corporation issues preferred stock previously authorized but unissued, for outstanding common stock. The Commissioner does not undertake to explain how this could benefit the corporation as distinguished from the stockholders.

The words "germane to the continuance of the business of" obviously do not mean "for the sole benefit of the corporation as such." What they mean is that the exchange must be one consistent with a continuance of such business, and not a mere temporary expedient "masquerading as a corporate reorganization" and "put to death" immediately after its tax avoiding purpose had been supposedly accomplished.

The illustrations in the Regulations, as well as the passages not quoted by the Commissioner in the body of his brief, or by the Court below in Judge O'Connell's opinion, make the construction now claimed for the word "germane" impossible.

The gist of the Regulations is that under the *Gregory* case, the exchange must be a genuine one, not a sham, and that it must be followed by a continuation of the business, and not the immediate dissolution of the corporation constructed solely to effect a tax-avoiding scheme.

That the present recapitalization was a genuine and permanent one is specifically admitted by the Commissioner.[2] Nor is it disputed[3] that the business of the company is still going on as usual.

(2) "We are not here contending that the plan of recapitalization should be disregarded, or that the securities issued in pursuance of it are unreal or not valid in accordance with their tenor" (p. 33, Commissioner's brief).

(3) Commissioner's brief, bottom of p. 30.

As stated by the Court below (Rec. p. 109 note 3), there is no specific finding in the case at bar, as there is in the *Adams* case argued at the same time, that the tax saving to the corporation by the exchange of interest-bearing debentures for common stock was to the advantage of the corporation as distinguished from the stockholders. This fact, however, was present in the case and is covered by our third "Questions Presented" and "Specification of Errors."

If this Court should sustain the position of the petitioner in the *Adams* case, the Court might, it is submitted, recognize the presence of the point in the case, or, if it deemed proper, send the case back to the Tax Court for a specific finding.

In connection with the supposed infallibility which the Commissioner apparently claims for the legal conclusions of the Tax Court, it is not without significance that on both branches of the case, the present brief for the Commissioner disregards the principal conclusions by the Tax Court.

On the main point the Commissioner now relies primarily, not on the *Gregory* decision, but on the Regulations to which the Tax Court did not once refer.

On the second point, the Tax Court relied on Section 115(g), providing that where a corporation "cancels or redeems its stock" in such a manner as to be "essentially equivalent to a taxable dividend" it will be so considered (Rec. p. 97a note 2). Recognizing, doubtless, that under the stipulation, adopted by the Tax Court, these debentures were issued in part *exchange* for the old stock, the Commissioner now expresses indifference as to whether the debentures are taxable, as the Tax Court held, under Section 115(g) or as he now suggests (Commissioner's brief p. 26) under Section 115(a).

The Commissioner now contends (p. 32), that this case comes under Sec. 112(c)(2), providing that distributions in a reorganization having the effect of a distribution of a tax-

able dividend must be so treated. If, however, because this case lacks a corporate business purpose it is not to be held a reorganization, then Sec. 112(c)(2) by its terms is not applicable. Recognizing this, the Commissioner now falls back on the proposition that 115(a) and (g) must be read "as a gloss" on Sec. 112(c)(1) providing that the gains, if any, to the recipient shall be recognized to the extent of the fair market value of the "other property" received in the exchange. In such case, however, the capital gains provision of Section 117 would be applicable. Also, if it is assumed, as the Commissioner does on the bottom of page 31, that there was here a reorganization, admittedly no tax was due, since no cash was distributed (as it was in the *Bedford* case, 325 U. S. 283), stock having here been "exchanged solely for stock and securities," Section 112(b)(3).

Respectfully submitted,

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No. 287

In the Supreme Court of the United States

OCTOBER TERM, 1946

J. ROBERT BAZLEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Argument	6
Conclusion	19
Appendix	20

CITATIONS

Cases:

Adams v. *Commissioner*, 5 T. C. 351	14
Adams v. *Commissioner*, 155 F. 2d 246	8, 14
Annis Furs v. *Commissioner*, 2 T. C. 1096	14, 15
Bass v. *Commissioner*, 129 F. 2d 300	15
Black, Starr & Frost-Gorham v. *United States*, 39 F. Supp. 108	14
Claude Neon Lights v. *Commissioner*, 35 B. T. A. 424	15
Cogan v. *Commissioner*, 97 F. 2d 996, affirming 36 B. T. A. 639	14
Commissioner v. *Capento Securities Corp.*, 140 F. 2d 382	15
Commissioner v. *Court Holding Co.*, 324 U. S. 331	13
Commissioner v. *Estate of Bedford*, 325 U. S. 283	15, 18
Commissioner v. *Kolb*, 100 F. 2d 920	15
Commissioner v. *Tower*, decided Feb. 25, 1946	13
Dobson v. *Commissioner*, 320 U. S. 489	18
Docherty v. *Commissioner*, 47 B. T. A. 462	15
Electrical Securities Corp. v. *Commissioner*, 92 F. 2d 593	14
Fischer v. *Commissioner*, 46 B. T. A. 999	15
Gregory v. *Helvering*, 293 U. S. 465	8, 10, 11, 13, 14
Griffiths v. *Commissioner*, 308 U. S. 355	13
Handbird Holding Corp. v. *Commissioner*, 32 B. T. A. 238	14
Heady v. *Commissioner*, decided July 24, 1945	14
Helvering v. *Elkhorn Coal Co.*, 95 F. 2d 732, certiorari denied, 305 U. S. 605, rehearing denied, 305 U. S. 676	14
Helvering v. *Gregory*, 69 F. 2d 809	10
Helvering v. *Winmill*, 305 U. S. 79	11
Higgins v. *Smith*, 308 U. S. 473	13
Hill v. *Commissioner*, 66 F. 2d 45	18
Kelley, John, Co. v. *Commissioner*, decided Jan. 7, 1946	13
Lea v. *Commissioner*, 96 F. 2d 55	15
Lusthaus v. *Commissioner*, decided Feb. 25, 1946	13
Marcher v. *Commissioner*, 32 B. T. A. 76	14

Cases—Continued	Page
Minnesota Tea Co. v. *Helvering*, 302 U. S. 609	13
Okonite Co. v. *Commissioner*, 155 F. 2d 248	15
Schoo v. *Commissioner*, 47 B. T. A. 459	15
Taft v. *Commissioner*, 304 U. S. 351	11
Wellhouse v. *Commissioner*, 3 T. C. 363	14
Statutes:	
Internal Revenue Code:	
Sec. 112 (26 U. S. C., Sec. 112)	7, 10, 20
Sec. 115 (26 U. S. C., Sec. 115)	6, 7, 9, 17, 18, 21
Sec. 117 (26 U. S. C., Sec. 117)	7, 23
Miscellaneous:	
H. Rep. No. 179, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 241, 251)	12
H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2) 554, 563–565)	12, 13
S. Rep. No. 398, 68th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 266, 277)	12
S. Rep. No. 558, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 586, 599)	13
Treasury Regulations 86:	
Art. 112 (g)–1	11
Art. 112 (g)–2	11
Treasury Regulations 94:	
Art. 112 (g)–1	11
Art. 112 (g)–2	11
Treasury Regulations 101:	
Art. 112 (g)–1	11
Art. 112 (g)–2	11
Treasury Regulations 103:	
Sec. 19.112 (g)–1	10, 24
Sec. 19.112 (g)–2	10, 26
Treasury Regulations 111:	
Sec. 29.112 (g)–1	11
Sec. 29.112 (g)–2	11

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 89a–102a) and the dissenting opinion (R. 102a–104a) are reported at 4 T. C. 897. The opinion of the Circuit Court of Appeals (R. 126–136) and the dissenting opinion (R. 137–140) are reported at 155 F. 2d 237.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1946. (R. 141.) The petition for a writ of certiorari was filed on July

11, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the Tax Court correctly found that the recapitalization of a corporation, pursuant to which the taxpayer exchanged the common stock owned by him for new common stock and debenture bonds, lacked a legitimate corporate business purpose, so that it failed to qualify as a "reorganization" within the meaning of Section 112 (g) (1) (E) of the Internal Revenue Code.

2. If the transaction was not a reorganization within the statutory definition, as both courts below held, whether the Circuit Court of Appeals erred in accepting the Tax Court's finding that the distribution of earnings or profits in the form of debenture bonds was essentially equivalent to the distribution of a taxable dividend under Section 115 (a) and (g) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations are printed in the Appendix, *infra*, pp. 20–26.

STATEMENT

The pertinent facts found by the Tax Court (R. 90a–95a) may be summarized as follows:

Taxpayer, a resident of Pottsville, Pennsylvania, is the president and treasurer of J. Robert

Bazley, Inc., a Pennsylvania corporation (hereinafter referred to as "Corporation"), organized on May 1, 1930, with an authorized capital of 1,000 shares of a par value of $100 per share. On February 1, 1939, taxpayer owned 798 shares, his wife, Alice H. Bazley, owned 201 shares, and one Alfred Day owned one share of the Corporation's 1,000 shares of outstanding stock. The three stockholders constituted the directors of the Corporation. (R. 90a–91a.)

The Corporation is engaged in a general heavy contracting business. Shortly prior to 1939 it was engaged almost entirely in mining coal by the open-pit method and then first considered going into road building work, which is hazardous and requires considerable working capital. Many road-building contractors have failed. (R. 91a.)

At a special meeting of the Corporation's directors on February 6, 1939, a plan of reorganization was adopted and authority given to increase the capital stock of the Corporation as provided in the plan. The plan recited that on February 1, 1939, the capital of the Corporation was $100,000 and its earned surplus was $855,783.82. It provided for issuance, in exchange for the old stock, of 5,000 shares of new common stock of no par value but with a stated value of $300,000, and $400,000 principal amount of six percent 20-year debenture bonds dated February 1, 1939, callable in whole or in part. The old

stock was to be cancelled. The plan provided for reduction of the earned surplus to $255,783.82 as a result of the increased capitalization and issuance of debenture bonds. (R. 92a–93a.)

On February 16, 1939, the stockholders approved and authorized the proposed plan of reorganization, and on March 6, 1939 the Commonwealth of Pennsylvania approved the amendment to the Corporation's articles of incorporation providing for the increase of its stock. On March 16, 1939, the plan was carried out and the changes in capitalization were entered in the Corporation's books of account. As an incident thereof $200,000 of earned surplus was transferred to capital stock account and $400,000 of earned surplus was transferred to debenture bonds payable account. On March 16, 1939, the 5,000 shares of new stock had a fair market value of not less than $300,000 and the 20-year bonds had a fair market value of not less than $400,000, their face amount. (R. 93a–94a.)

The reasons for adopting the plan of recapitalization were that the stockholders, by obtaining debenture bonds for their stock would receive a more readily marketable and less fluctuating security, in case it was necessary for the estate of a deceased shareholder to liquidate his investment to meet inheritance tax or for other purposes; that if it became necessary for a stockholder to sell some portion of his investment, the bonds

could be sold without reducing the Bazley family's stock control of the Corporation; the contemplated entry into the hazardous business of road construction made it desirable for the stockholders to have bonds, so as to be in a position to share with general creditors to the extent of the debentures, if the business did not succeed; and since the value of the Corporation's plant and equipment ($719,782.41 as of April 30, 1939) was large in relation to its capitalization of $100,000, and since the equipment had been purchased by using funds acquired through accumulating $855,783.07 of earnings and profits, it was thought advisable to reflect a more permanent dedication of these earnings to corporate use, by reducing the surplus available for dividends and transferring a part thereof to capital stock and a part to long-term debt represented by the 20-year bonds. (R. 91a–92a.)

There was no legitimate purpose of the Corporation's business in the issuance and distribution to the stockholders of $400,000 in debenture bonds. (R. 95a.)

In the reorganization the taxpayer received 3,990 shares of new stock and debenture bonds in the principal amount of $319,200 in exchange for 798 shares of old stock. (R. 94a.) In his notice of deficiency for 1939, the Commissioner included in the taxpayer's income the amount of $319,200, representing the fair market value of the bonds of

the Corporation received in exchange for its common stock. (R. 10a, 95a.)

The Tax Court found that, in the absence of a legitimate corporate reason for recapitalizing the Corporation to issue debentures, the distribution of the debentures was not pursuant to a reorganization, as defined by statute; that the distribution was essentially equivalent to the distribution of a taxable dividend; and is taxable as a dividend. (R. 96a–102a.) Five judges dissented. (R. 102a–104a.)

The Circuit Court of Appeals sitting en banc, affirmed (R. 126–136), two judges dissenting (R. 137–140).

ARGUMENT

The judgment of the Circuit Court of Appeals is correct and is not in conflict with any other decision, so as to warrant further review of the case by this Court.

The opinion of the lower court (R. 126–136) points out that the distribution of the Corporation's debenture bonds segregated earned surplus in the face amount of the bonds and represented a distribution of its accumulated earnings and profits (see Section 115 (b) of the Internal Revenue Code (Appendix, *infra*)); that the distribution conforms to the definition of a dividend in Section 115 (a) (Appendix, *infra*); and that the Tax Court's findings that the distribution of the bonds was essentially equivalent to the distri-

bution of a taxable dividend and that the bonds, to the extent of their value (Section 115 (j) of the Code, Appendix, *infra*), are taxable as a dividend under Section 115 (g) of the Code (Appendix, *infra*), are fully warranted. The court then considered whether the circumstance that the distribution of the debenture bonds was cast in the form of an exchange pursuant to a recapitalization operated to relieve the stockholders of paying a tax on the distribution as a dividend.[1] It concluded that, as the Tax Court

[1] If the exchange was made pursuant to a plan of recapitalization which is to be given effect as a reorganization for tax purposes, Section 112 (b) (3) of the Internal Revenue Code (Appendix, *infra*) would apply to prevent any present recognition of the gain on receipt of the bonds. And as the Tax Court pointed out (R. 102a), when the bonds were sold, exchanged, or retired, the gain thereon would be taxed not as a dividend, but as capital gain with the accompanying limitations on taxability. See Section 117 (b) and (f) of the Internal Revenue Code (Appendix, *infra*). Thus, the distribution of profits would escape taxation as a dividend. It is true that, if the transaction were to be recognized as a reorganization, under Section 115 (h) (Appendix, *infra*) the issuance of bonds would not be deemed a distribution of earnings for tax purposes and the earnings would remain available for subsequent dividends; yet by the repeated device of issuing debentures in a so-called recapitalization, not required by business reasons of the corporation, and then redeeming them, a corporation could in fact distribute all its earnings periodically, so that it would never have to declare any dividend, or at most would have to declare only small dividends, which would be recognized as a reduction of earnings by Section 115 (h) and be taxed as a dividend. This possibility furnishes a persuasive reason for concluding that only legitimate recapitalizations required by business

found the recapitalization was not induced by any legitimate business reason of the corporation, it had no substance for tax purposes, and, disregarding form, the distribution of bonds was to be treated as what it was in fact, a means of distributing corporate earnings and hence a dividend.[2]

1. Taxpayer seeks a writ of certiorari on the ground principally (Pet. 5–6, Br. 13–14) that the conclusion of the lower court that there was no "reorganization" as intended by the statutory definition of that term involves an unjustified construction of this Court's reasoning in *Gregory v. Helvering*, 293 U. S. 465. We believe that decision laid down the broad principle that a transaction cast in the form of a reorganization does not fall within the intent of the statutory definition of reorganization unless it occurs pursuant to a plan dealing with the reorganization of the corporate business. This manifestly would exclude a plan of recapitalization devised solely to serve some personal advantage of the stockholders of a closely held corporation and having no relation to the corporation's business, for it was a purpose of this kind which was condemned in the *Gregory* case. Three of the reasons for the

---

exigencies of a corporation are to be given effect as statutory reorganizations.

[2] The same holding was made by the lower court in *Adams v. Commissioner*, 155 F. 2d 246, now pending before this Court on petition for writ of certiorari, No. 209,

recapitalization here, as the Tax Court's findings and discussion show (R. 91a–92a, 99a–102a), were solely personal to the taxpayer and his wife, having no relation to the needs of the corporation's contracting business, and the fourth was not a legitimate corporate business purpose.[3] Indeed, the Tax Court inferred that the stockholders "may well have endeavored to establish a foundation for participating in the corporate profits without subjecting the distributions to taxation as dividends" (R. 102a), an objective closely analogous to that in the *Gregory* case. Taxpayer does not challenge the Tax Court's findings of purpose or contend that they include a corporate business purpose, if such a purpose is required. (Pet. 2–3, 5.)

[3] This fourth purpose was the desire to reflect a more permanent dedication to corporate use of the $855,783.07 of accumulated earnings, already used to purchase equipment, by reducing surplus available for dividends and transferring a portion to capital stock and to the debenture bond debt. (R. 92a.) But the Corporation had the same use of the earnings, invested in equipment, regardless of the account in which the earnings stood on its books, and as the Tax Court pointed out (R. 100a), the desire to remove the earnings as a source for dividend payments is not a legitimate business purpose of the Corporation, since it involves an attempted circumvention of Section 115 (a) and (b) which regard such a segregation of accumulated earnings as a dividend. Thus, this purpose also can be viewed as one personal to the stockholders because it was an effort to allocate earnings to them without occasioning the tax consequences which would ensue if the earnings were distributed directly.

Nor do we understand that the *Gregory* decision rests on the premise that the transaction there was only a "fraud" or a "sham." As this Court said (p. 469) a "new and valid corporation was created." The transactions were a sham only in the sense that they "were no part of the conduct of the business of either or both companies." *Helvering* v. *Gregory*, 69 F. 2d 809, 811 (C. C. A. 2d).

Accordingly, we believe the lower courts correctly relied on the decision of *Gregory* v. *Helvering, supra*, in concluding that the recapitalization was not a reorganization within the intent of the statutory definition of that term. But the holding was also required by the long standing administrative interpretation as to the intent of the statutory definition of reorganization and by legislative expressions as to the meaning of the term. Sections 19.112 (g)-1 and 19.112 (g)-2 of Treasury Regulations 103 (Appendix, *infra*) provide that the readjustments effected in the consummation of a plan of reorganization under Section 112 (g) of the Code (Appendix, *infra*), which includes reorganization by recapitalization, must be required by "business exigencies" and "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."[4]

[4] These requirements qualify the whole discussion of reorganization in the Regulations. Thus, the example given

These provisions were first contained in Articles 112 (g)–1 and 112 (g)–2 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, approved February 11, 1935, and have been continued without change since that time.[5] Under familiar principles Congress is deemed to have approved them by reason of the reenactment of the statutory definition without amendment in this respect. *Helvering* v. *Winmill*, 305 U. S. 79; *Taft* v. *Commissioner*, 304 U. S. 351. The lower court approved these Regulations as reasonable and a valid exercise of the rule-making power. As it stated, it would have had to hold the Regulations invalid, in order to reverse the Tax Court, since the recapitalization was not [illegible] business exigencies, nor was it [illegible] tinuance of the corporate busine[illegible]

The Regulations incorporate [illegible] Congress, as well as what we under[illegible] been the view of this Court in [illegible]

in the Regulations quoted by taxpayer (Pet. [illegible], as to what constitutes a recapitalization, has implicit in it the requirement of a corporate business exigency as causing the exchange of unissued authorized preferred stock for outstanding common stock.

[5] Articles 112 (g)–1 and 112 (g)–2 of Treasury Regulations 94, promulgated under the Revenue Act of 1936, and of Treasury Regulations 101, promulgated under the Revenue Act of 1938; Sections 29.112 (g)–1 and 29.112 (g)–2 of Treasury Regulations 111, promulgated under the Internal Revenue Code for application to years beginning after December 31, 1941.

vering, supra: H. Rep. No. 179, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 241, 251) and S. Rep. No. 398, 68th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 266, 277) stated, in reporting the Revenue Bill of 1924, that the Congressional policy was to exempt from tax the gain on reorganization exchanges so that—

> ordinary business transactions will not be prevented on account of the provisions of the tax law.

Again, in connection with the pending Revenue Bill of 1934, H. Rep. No. 704, 73rd Cong., 2d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 554, 564) stated that—

> the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, "control" being defined as an 80-percent ownership; and (3) changes in the capital structure or form of organization.
>
> By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, *legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted.* Furthermore, the retention of the other reorganization provisions will prevent large losses

> from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise *which are substantially the same as their original investments.* [*Italics supplied.*]

S. Rep. No. 558, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 586, 599), is consistent. As the lower court pointed out (fn. 12, R. 133), the statutory reorganization and exchange provisions were amended and retained in the 1934 Act, instead of being abolished as a result of attempted abuses, in part because the courts had shown a tendency to give effect to the substance of a transaction, even though cast in the form of a reorganization.[8] See for a full discussion H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2) 554, 563–565).

As has been seen, the concept that a reorganization to fall within the statutory definition must be a commercial or financial transaction undertaken in the interests of the corporation's business

[8] Apart from the *Gregory* case, this Court has consistently treated the substance of a transaction as determining the tax consequences, rather than the form in which it occurred, where the form chosen was not due to business reasons. *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; cf. *Commissioner* v. *Tower*, decided February 25, 1946 (1946 P-H, par. 72016; *Lusthaus* v. *Commissioner*, decided February 25, 1946 (1946 P-H, par. 72015); *John Kelley Co.* v. *Commissioner*, decided January 7, 1946 (1946 P-H, par. 72009).

is not a new development as taxpayer asserts. (Br. 14–16.) To be sure, the precise factual situation in which a so-called recapitalization was brought about solely to serve the private purposes of the stockholders, without relation to the corporate business, has only recently been presented. See *Wellhouse* v. *Commissioner*, 3 T. C. 363; *Adams* v. *Commissioner*, 5 T. C. 351, affirmed, 155 F. 2d 246 (C. C. A. 3d), pending on petition for writ of certiorari, No. 209, this Term; *Heady* v. *Commissioner*, decided July 24, 1945 (1945 P-H T. C. Memorandum Decisions, par. 45,261), pending on appeal (C. C. A. 7th); cf. *Annis Furs* v. *Commissioner*, 2 T. C. 1096. Both the courts and the Tax Court in other factual situations have recognized the principle and applied it to other forms of reorganization where no corporate purpose was shown, at least since the promulgation of the Regulations and the decision in *Gregory* v. *Helvering*, 293 U. S. 465.[7] In the cases in which it has been found that a statutory reorganization occurred, the facts disclosed that the arrangement was undertaken in part for corporate business or

[7] See e. g. *Helvering* v. *Elkhorn Coal Co.*, 95 F. 2d 732 (C. C. A. 4th), certiorari denied, 305 U. S. 605, rehearing denied, 305 U. S. 679; *Cogan* v. *Commissioner*, 97 F. 2d 996 (C. C. A. 2d), affirming *per curiam*, 36 B. T. A. 639; *Electrical Securities Corp* v. *Commissioner*, 92 F. 2d 593 (C. C. A. 2d); *Black, Starr & Frost-Gorham* v. *United States*, 39 F. Supp. 109 (C. Cls.); *Marchetti* v. *Commissioner*, 32 B. T. A. 76; *Handbird Holding Corp.* v. *Commissioner*, 32 B. T. A. 238, 249.

financial reasons; hence, whether or not the necessity for a corporate purpose was specifically discussed, the cases are consistent with the rule that a purpose germane to the corporate business is essential to bring a transaction within the statutory definition of reorganization.*

In fact, the taxpayer does not assert that any case is in clear conflict with the decision below, but only that the decision is "irreconcilable" with *Commissioner* v. *Kolb*, 100 F. 2d 920 (C. C. A. 9th). (Pet. 7.) In that case the court stated that the reorganization had business purposes, both for the corporation and its stockholders, listing ten such purposes, but it did not hold that a purpose to benefit stockholders only would be sufficient, in the absence of purposes furthering

* For example, see *Okonite Co.* v. *Commissioner*, 155 F. 2d 248 (C. C. A. 3d); *Commissioner* v. *Capento Securities Corp.*, 140 F. 2d 382 (C. C. A. 1st); *Büss* v. *Commissioner*, 129 F. 2d 366 (C. C. A. 1st); *Lea* v. *Commissioner*, 96 F. 2d 55 (C. C. A. 2d); *Annis Furs* v. *Commissioner*, *supra*; *Fischer* v. *Commissioner*, 46 B. T. A. 999, dismissed June 3, 1943 (C. C. A. 6th); *Schoo* v. *Commissioner*, 47 B. T. A. 459; *Docherty* v. *Commissioner*, 47 B. T. A. 462; *Claude Neon Lights* v. *Commissioner*, 35 B. T. A. 424, 428. In *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, as in many cases, the purpose of the recapitalization was to eliminate accumulated dividends on preferred stock so as to better the corporation's financial position. We dispute taxpayer's claim (Br. 15) that the Tax Court has sustained recapitalizations clearly for the sole benefit of stockholders. The cases cited (fn. 4) do not sustain the claim. In all of them a corporate reason for the transaction is either disclosed in the facts and discussion, or is assumed.

the corporation's business also. The lower court here did not hold, nor do we contend, that the reorganization must be *solely* for the corporation's benefit, without any advantage to the stockholders.

The dissenting opinion below on which taxpayer relies (Br. 18–19) is based largely on the view that a corporation and its stockholders may not be disassociated and that a transaction which promotes the stockholders' interest has a purpose from the corporation's point of view. While it may be true that the general purpose of a corporation is to carry on its business for the ultimate benefit of its stockholders, it does not follow that the corporate purposes of a company engaged in a commercial business enterprise (heavy contracting) include the carrying out of a capital change merely because its two stockholders desire to change their securities for personal reasons. Even assuming, *arguendo* only, that such a transaction could in a loose sense be construed as having a "corporate" purpose, it is not one brought about by business exigencies, germane to the corporate business, or one which strengthens the financial condition of the business enterprise. Not only is a corporate purpose required, but it must be a purpose connected with the corporation's business to fulfil the statutory intent as expressed by this Court, by Congress, and by the Regulations.

The corporate business purpose test is not vague and unworkable, as taxpayer argues. (Br. 17–18.) Whether the required purpose motivated a particular transaction is a factual question. In most cases the facts will clearly disclose whether a recapitalization serves a corporation's business interests in some respect or solely the unrelated and private interests of its stockholders, but in doubtful cases the question, like other disputed questions of fact, can be resolved by the trier of facts. The Tax Court has not expressed the view that the test is unworkable.

2. The taxpayer seeks a writ of certiorari on the ground also (Pet. 8, Br. 19–22) that the lower court "changed" the finding of the Tax Court that the debentures and new stock were received in exchange for the old stock, and maintains that, even though there was no statutory reorganization so that the receipt of the bonds would be tax-free, the income realized on receipt of the bonds must be taxed as a capital gain, rather than as a dividend, because they were received in an "exchange."[9] The Tax Court did indeed find that the distribution of the bonds was cast in the

[9] The result of this contention would be that the distribution of earnings in the face amount of the bonds would forever escape taxation as a dividend. Section 115 (h) would not apply to keep the earnings intact for future distribution as dividends for tax purposes, since the distribution of bonds would be recognized as a taxable one.

form of an exchange pursuant to a recapitalization but its view was that in substance the transaction was a medium for distributing the corporate earnings. It disregarded the form and looked through to substance, treating the arrangement for tax purposes as a dividend distributing transaction, rather than an exchange. The lower court, consistently with *Dobson* v. *Commissioner*, 320 U. S. 489, accepted this view as warranted by the facts. It did not alter the finding that the bonds were received in an exchange; instead, it agreed with the Tax Court that substance, rather than form, governs the tax consequences. Taxpayer cites no authority compelling the holding that a distribution which is in substance a dividend as defined in Section 115 (a) cannot be so treated under Section 115 (g), simply because it is made in the form of an exchange.[10] Cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283.

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[10] Taxpayer does not argue that Section 115 (g) can not apply to a distribution of property in cancellation of old stock, which is cast in the form of an exchange. In any event, the section is not so restricted. It in terms applies to any cancellation of stock made under such circumstances as to be the equivalent of a dividend and is not confined to such cancellations as fall within the statutory definition of a partial liquidation. (See Section 115 (i) (Appendix, *infra*).) It is immaterial under Section 115 (g) that simultaneously with the cancellation of the old stock a different class of stock was issued. *Hill* v. *Commissioner*, 66 F. 2d 45 (C. C. A. 4th).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1946.

APPENDIX.

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchange Solely in Kind.*—

* * * * *

(2) *Stock for Stock of Same Corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) *Stock for Stock on Reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(g) [as amended by Section 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862]

Definition of Reorganization.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its vot-

ing stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected. (26 U. S. C., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * * *

(26 U. S. C., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has

been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * * *

(26 U. S. C., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.112 (g)–1. *Purpose and scope of exception of reorganization exchanges.*—*Purpose*: Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a

continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. * * * In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up.

* * * * *

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must

provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

SEC. 19.112 (g)-2. *Definition of terms.*—

* * *

* * * * *

The term "plan of reorganization" has reference to a ~~consummated~~ transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE

No. 287

In the Supreme Court of the United States

OCTOBER TERM, 1946

J. ROBERT BAZLEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and Regulations involved	3
Statement	3
Summary of Argument	6
Argument:	
Introduction	9
I. The transaction does not qualify as a statutory reorganization since it was not actuated by a purpose germane to the company's business	11
II. The distribution of debenture bonds was properly taxed as a dividend	24
Conclusion	35
Appendix	36

CITATIONS

Cases:

Adams v. *Commissioner*, 5 T. C. 351, affirmed, 155 F. 2d 246, certiorari granted, October 14, 1946	19
Allen v. *Trust Co. of Georgia*, 326 U. S. 630	20
Annis Furs, Inc. v. *Commissioner*, 2 T. C. 1096	19
Bass v. *Commissioner*, 45 B. T. A. 1117	19
Base v. *Commissioner*, 129 F. 2d 300	19, 22
Beretta v. *Commissioner*, 141 F. 2d 452, certiorari denied, 323 U. S. 720	30
Black, Starr & Frost-Gorham v. *United States*, 39 F. Supp. 109	18
Brown v. *Commissioner*, 79 F. 2d 73	27
Capento Securities Corp. v. *Commissioner*, 47 B. T. A. 691	19
Chattanooga Sav. Bank v. *Brewer*, 17 F. 2d 79, certiorari denied, 274 U. S. 751	26
Christopher v. *Burnet*, 55 F. 2d 527	26
Coca-Cola Co. v. *United States*, 47 F. Supp. 109	19
Cohen v. *Commissioner*, 97 F. 2d 996, affirming, *per curiam*, 36 B. T. A. 639	18
Cohan v. *Commissioner*, 39 F. 2d 540	23
Commissioner v. *Babson*, 70 F. 2d 304	27
Commissioner v. *Capento Securities Corp.*, 140 F. 2d 382	19, 22
Commissioner v. *Champion*, 78 F. 2d 513	27
Commissioner v. *Court Holding Co.*, 324 U. S. 331	33
Commissioner v. *Estate of Bedford*, 325 U. S. 283	22, 26, 31, 32, 35
Commissioner v. *Gilmore's Estate*, 130 F. 2d 791	19, 22

Cases—Continued

	Page
Commissioner v. *Kolb*, 100 F. 2d 920	19
Commissioner v. *Tower*, 327 U. S. 280	33
Corliss v. *Bowers*, 281 U. S. 376	33
De Nobili Cigar Co. v. *Commissioner*, 1 T. C. 673, affirmed, 143 F. 2d 436	27
Dobson v. *Commissioner*, 320 U. S. 489	20, 31
Docherty v. *Commissioner*, 47 B. T. A. 462	19
Doerschuck v. *United States*, 274 Fed. 739	26, 31
Dunton v. *Clauson*, decided September 27, 1946	31
Edwards v. *Douglas*, 269 U. S. 204	30
Electrical Securities Corp. v. *Commissioner*, 92 F. 2d 503	18
Faris v. *Helvering*, 71 F. 2d 610, certiorari denied, 293 U. S. 584	27
Fischer v. *Commissioner*, 46 B. T. A. 999	19, 22
Fitch v. *Helvering*, 70 F. 2d 583	26
Flanagan v. *Helvering*, 116 F. 2d 937	29, 30
Gregory v. *Helvering*, 293 U. S. 465	15, 17, 24
Griffiths v. *Commissioner*, 308 U. S. 355	17, 33
Haass v. *Commissioner*, 29 B. T. A. 900, affirmed, January 14, 1936	22
Hadley v. *Commissioner*, 36 F. 2d 543	26
Harrison v. *Schaffner*, 312 U. S. 579	33
Heady v. *Commissioner*, decided July 24, 1945	20
Hellmich v. *Hellman*, 276 U. S. 233	30
Helvering v. *Canfield*, 291 U. S. 163	30
Helvering v. *Clifford*, 309 U. S. 331	33
Helvering v. *Elkhorn Coal Co.*, 95 F. 2d 73; certiorari denied, 305 U. S. 605	18
Helvering v. *Limestone Co.*, 315 U. S. 179	18
Helvering v. *National Grocery Co.*, 304 U. S. 282	20, 24
Helvering v. *Safe Deposit Co.*, 316 U. S. 56	23
Helvering v. *Wamsutta*, 305 U. S. 79	12
Hender v. *Commissioner*, 98 F. 2d 934	18
Higgins v. *Smith*, 308 U. S. 473	17, 33
Hill v. *Commissioner*, 66 F. 2d 45	35
Hirsch v. *Commissioner*, 124 F. 2d 24	27
Kelley, John, Co. v. *Commissioner*, 326 U. S. 521	18, 21, 33
Kirschenbaum v. *Commissioner*, 155 F. 2d 23, certiorari denied, October 14, 1946	27
Lea v. *Commissioner*, 96 F. 2d 55	19
Lusthaus v. *Commissioner*, 327 U. S. 293	33
McCaughn v. *Real Estate Co.*, 297 U. S. 606	20
McGuire v. *Commissioner*, 84 F. 2d 431, certiorari denied, 299 U. S. 591	30
Minnesota Tea Co. v. *Helvering*, 302 U. S. 609	17, 32
Morningville v. *Commissioner*, 135 F. 2d 201	22
Okonite Co. v. *Commissioner*, 155 F. 2d 248, certiorari denied, October 28, 1946	19, 22

Cases—Continued

	Page
Palmer v. *Commissioner*, 302 U. S. 63	26
Paramount-Richards Th. v. *Commissioner*, 153 F. 2d 602	27
Randolph v. *Commissioner*, 76 F. 2d 472	27
Regensburg v. *Commissioner*, 144 F. 2d 41, certiorari denied, 323 U. S. 783	27
Schoo v. *Commissioner*, 47 B. T. A. 459	19
Shenandoah Rayon Corp. v. *Commissioner*, 122 F. 2d 268, certiorari denied, 314 U. S. 696	22
Smith v. *United States*, 121 F. 2d 692	30
Starr v. *Commissioner*, 82 F. 2d 964, certiorari denied, 298 U. S. 680	22
Tait v. *Commissioner*, 304 U. S. 351	12
Thermoid Co. v. *Commissioner*, 155 F. 2d 589	19, 22
Timberlake v. *Commissioner*, 132 F. 2d 259	27
Welch v. *Helvering*, 290 U. S. 111	21
Wellhouse v. *Commissioner*, 3 T. C. 363	19
Wilcox v. *Commissioner*, 137 F. 2d 136	30
Wilmington Trust Co. v. *Helvering*, 316 U. S. 164	20
Woods, J. R., & Sons, Inc. v. *United States*, 46 F. Supp. 877	19

Statutes:

Internal Revenue Code:	
Sec. 22 (26 U. S. C. 1940 ed., Sec. 22)	24, 36
Sec. 112 (26 U. S. C. 1940 ed., Sec. 112)	7, 8, 26, 32, 33, 34, 36
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	9, 25, 34, 38
Sec. 117 (26 U. S. C. 1940 ed., Sec. 117)	8, 40
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Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 112	15
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Miscellaneous:

Berle, *Studies in the Law of Corporation Finance* (1928), pp. 20, 24	23
Fahey, *Income Tax Definition of "Reorganization,"* 39 Col. L. Rev. 933, 937, 969 (1939)	17
H. Conference Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939-1 Cum. Bull. (Part 2) 361-362)	28
H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939-1 Cum. Bull. (Part 2), 315, 318)	29
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H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12-14 (1939-1 Cum. Bull. (Part 2) 554, 563-565)	13, 14
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Miscellaneous—Continued

	Page
S. Rep. No. 558, 73d Cong., 2d Sess., p. 17 (1939-1 Cum. Bull. (Part 2) 586, 599)	14
Treasury Regulations 86:	
Art. 112 (g)-1	12
Art. 112(g)-2	12
Art. 115-9	28
Treasury Regulations 94:	
Art. 115-9	28
Treasury Regulations 101:	
Art. 115-9	28
Treasury Regulations 103:	
Sec. 19.22 (a)-1	41
Sec. 19.112 (g)-1	11, 42
Sec. 19.112 (g)-2	7, 11, 43
Sec. 19.112 (g)-4	44
Sec. 19.112(g)-5	45
Sec. 19.115-8	46
Sec. 19.115-9	28, 46
Sec. 19.115-10	48
Sec. 19.115-11	48
Treasury Regulations 111:	
Sec. 29.115-9	28

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 287

J. ROBERT BAZLEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 89–102) and the dissenting opinion (R. 102–104) are reported at 4 T. C. 897. The opinion of the Circuit Court of Appeals (R. 126–136) and the dissenting opinion (R. 137–140) are reported at 155 F. 2d 237.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 16, 1946. (R. 141.) The petition for a writ of certiorari was filed on July 11, 1946, and was granted on October 14, 1946.

(R. 142.) The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Pursuant to a plan of readjustment of corporate structure, the taxpayer-stockholder surrendered his stock and received five new shares of stock and $400 in debentures for each share of old stock. The accumulated earnings and profits of the corporation were considerably in excess of the debentures thus distributed. The principal questions presented are:

1. Whether the transaction constituted a "reorganization" within the meaning of Section 112 (g) (1) of the Internal Revenue Code, so as to exempt the receipt of the debentures from income tax. The answer to this question depends upon whether the Tax Court and the court below correctly held that a "reorganization" under the statute exists only where the transaction has a legitimate corporate business purpose, and whether the Tax Court's finding that there was no such purpose here was properly affirmed by the court below.

2. Whether, if it be held that there was not a statutory reorganization, the distribution of the debentures should be treated as an ordinary dividend under Sections 22 (a) and 115 of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set out in the Appendix, infra, pp. 36 to 50.

STATEMENT

The pertinent facts found by the Tax Court (R. 90–95) may be summarized as follows:

The taxpayer, a resident of Pottsville, Pennsylvania, is the president and treasurer of J. Robert Bazley, Inc., a Pennsylvania corporation (hereinafter referred to as "Corporation"), organized on May 1, 1930, with an authorized capital of 1,000 shares of a par value of $100 per share. On February 1, 1939, the taxpayer owned 798 shares, his wife, Alice H. Bazley, owned 201 shares, and one Alfred Day owned one share of the Corporation's 1,000 shares of outstanding stock. The three stockholders constituted the board of directors of the Corporation. (R. 90–91.)

The Corporation is engaged in a general heavy contracting business. Shortly prior to 1939 it was engaged almost entirely in mining coal by the open-pit method and then first considered going into road building work, which is financially hazardous and requires considerable working capital. Many road building contractors have failed. (R. 91.)

At a special meeting of the Corporation's directors on February 6, 1939, a plan of reorganiza-

tion was adopted and authority given to increase the capital stock of the Corporation as provided in the plan. The plan recited that on February 1, 1939, the capital of the Corporation was $100,000 and its earned surplus was $855,783.82. It provided for issuance, in exchange for the old stock, of 5,000 shares of new common stock of no par value but with a stated value of $300,000, and $400,000 principal amount of six per cent 20-year debenture bonds dated February 1, 1939, callable in whole or in part. The old stock was to be cancelled. The plan provided for reduction of the earned surplus to $255,782.82 as a result of the increased capitalization and issuance of debenture bonds. (R. 92–93.)

On February 16, 1939, the stockholders approved and authorized the proposed plan of reorganization, and on March 6, 1939, the Commonwealth of Pennsylvania approved the amendment to the Corporation's articles of incorporation providing for the increase of its stock. On March 16, 1939, the plan was carried out and the changes in capitalization were entered in the Corporation's books of account. As an incident thereof $400,000 of earned surplus was transferred to debenture bonds payable account. On March 16, 1939, the 5,000 shares of new stock had a fair market value of not less than $300,000 and the 20-year bonds had a fair market value of not less than $400,000, their face amount. (R. 93–94.)

The reasons for adopting the plan of recapitalization were that the stockholders, by obtaining debenture bonds for their stock would receive a more readily marketable and less fluctuating security, in case it was necessary for the estate of a deceased shareholder to liquidate his investment to meet inheritance tax or for other purposes; that if it became necessary for a stockholder to sell some portion of his investment, the bonds could be sold without reducing the Bazley family's stock control of the Corporation; the contemplated entry into the hazardous business of road construction made it desirable for the stockholders to have "funds," so as to be in a position to share with general creditors to the extent of the debentures, if the business did not succeed; and since the value of the Corporation's plant and equipment ($719,782.41 as of April 30, 1939) was large in relation to its capitalization of $100,000, and since the equipment had been purchased by using funds acquired through accumulating $855,783.07 of earnings and profits, it was thought advisable to reflect a more permanent dedication of these earnings to corporate use, by reducing the surplus available for dividends and transferring a part thereof to capital stock and a part to long-term debt represented by the 20-year debentures. (R. 91–92.)

The Tax Court explicitly found that "There was no legitimate purpose of the corporate busi-

ness of J. Robert Bazley, Inc., in the issuance and distribution to the stockholders of $400,000 in debenture bonds." (R. 95.)

The taxpayer, who originally held 798 shares of old stock, received 3,990 shares of new stock and debenture bonds in the principal amount of $319,200 upon consummation of the plan. (R. 94.) In his notice of deficiency for 1939, the Commissioner included in the taxpayer's income the amount of $319,200, representing the fair market value of the debentures thus received. (R. 95.)

The Tax Court held that, in the absence of a legitimate corporate reason for recapitalizing the Corporation to issue debentures, the distribution of the debentures was not pursuant to a reorganization, as defined by statute; that the distribution was essentially equivalent to the distribution of a taxable dividend, and is taxable as a dividend. (R. 96–102.) Five judges dissented. (R. 102–104.)

The Circuit Court of Appeals, sitting *en banc*, affirmed (R. 126–136), two judges dissenting (R. 137–140).

SUMMARY OF ARGUMENT

I

The Bazley corporation had over $800,000 in accumulated earnings and profits. As part of the transaction involved, $400,000 was subtracted

from its earnings and profits account, and debentures in a like amount were distributed to its stockholders. The taxpayer-stockholder herein seeks to avoid all tax with respect to that distribution on the ground that the transaction as a whole constituted a tax-free corporate reorganization under Section 112 (g) (1) of the Internal Revenue Code.

However, the Treasury Regulations restrict the reorganization provisions to transactions undertaken to promote the interests of the corporation, as such. Section 19.112 (g) (2) of Regulations 103 provides that the transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization". The reorganization provisions are not applicable to a transaction designed solely for the benefit of the stockholders. The result stated in the Regulations is supported by the legislative history and the decisions of the courts. The court below correctly sustained the Regulations as a "valid exercise of the rule making power." (R. 135.)

Further, the record amply supports the determination of the Tax Court that the facts of this case fail to bring it within the reorganization provisions as interpreted by the Regulations. The Tax Court explicitly found that "there was no legitimate purpose of the corporate business of J. Robert Bazley, Inc., in the issuance and

distribution to the stockholders of $100,000 in debenture bonds" (R. 95). The tax Court examined each of the alleged objectives behind the distribution of these debentures, and concluded that no one of them in fact constituted a *corporate* business purpose, although most of them were in the interests of the stockholders as individuals. All of the reasons advanced for the distribution of the debentures are consistent with the dominant purpose to pay a disguised dividend. And the court below properly affirmed the Tax Court when it found that the record supported the Tax Court's finding. It plainly stated that "To reverse the Tax Court in this case, we would have to hold the Treasury Regulations invalid" (R. 135).

II

The taxpayer makes an alternative argument that even if the transaction did not constitute a "reorganization", the distribution of the debentures did not constitute a taxable dividend, but should be regarded as part of the "exchange" whereby he surrendered his old stock and received new stock and debentures. If the transaction were thus to be treated as an "exchange" (under Section 112(c)(1)), only the excess of the value of the debentures over the basis of the proportionate amount of old stock would be taxable, and the amount of tax would be further limited by the capital gains provisions in Section 117.

The short answer to this contention is that the distribution of the debentures constitutes a dividend under Section 115 (a) and (g), regardless of the form of the distribution, whether it involves an "exchange" or takes some other form. Section 115 (a) defines a dividend as any distribution made out of earnings or profits accumulated after February 28, 1913, and Section 115 (g) deals with transactions which are the substantial equivalent of dividends, where "a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend * * *." The debenture distribution here involved is within the letter and spirit of Section 115. Although there was no formal declaration of a dividend, none is required under these provisions.

ARGUMENT

INTRODUCTION

The instant case presents a situation where a corporation, having a capital stock of $100,000, divided into 1,000 shares of the par value of $100 each, all being outstanding, and an earned surplus of some $800,000, changed its structure so as to have 5,000 shares of no-par value stock with a stated value of $60 per share, making a total of $300,000; debenture bonds aggregating $400,-

000 in principal amount and surplus of some $200,000. The new stock and debentures were issued in the ratio of five new shares and $400 face amount of debentures for each old share. The stockholders, viewing the transaction as a tax-free "reorganization," reported no gain. The Commissioner determined that the debentures constituted income in their face amount and assessed a deficiency accordingly.

The Tax Court sustained the Commissioner. It ruled that the absence of a legitimate corporate purpose prevented the transaction from qualifying as a reorganization under the statute, and that there was in fact no such purpose in the issuance and distribution of the debentures to the stockholders in this case. It said that the individual stockholders may well have endeavored to establish a foundation for participating in the corporate profits without subjecting the distributions to taxation as dividends (R. 102). It therefore held that there was not a statutory reorganization and also held that the debenture distribution was the substantial equivalent of a taxable dividend. Five judges dissented in the Tax Court.

The Circuit Court of Appeals, sitting *en banc*, affirmed, two judges dissenting; it held that the transaction clearly had the effect of a taxable dividend and that whatever the motives of the taxpayer may have been, he was taxable on the bonds received to the extent of their face value.

Two principal questions are thus presented: (1) whether the transaction constitutes a tax-free "reorganization"; and (2) whether, in the event that the first question is answered in the negative, the receipt of the debentures contitutes a taxable dividend.

I

THE TRANSACTION DOES NOT QUALIFY AS A STATUTORY REORGANIZATION SINCE IT WAS NOT ACTUATED BY A PURPOSE GERMANE TO THE COMPANY'S BUSINESS

The Treasury Regulations provide that the casting of a transaction in the form of a reorganization is not sufficient to render it a tax-free reorganization under the statute. Section 19.112 (g)-1 of Regulations 103 (Appendix, *infra*) provides not only that the precise specifications of the reorganization provisions of the law must be satisfied, but that their underlying assumptions must also be met. It specifies that "an ordinary dividend is to be treated as an ordinary dividend * * * even though the mechanics of a reorganization have been set up." Section 19.112 (g)-2 (Appendix, *infra*) states one of the underlying assumptions to be that the transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."

The Regulations thus reduce the area of possible conflict between the taxing provisions of the statute and the exemption provisions and,

under the specific terms of the Regulations, an ordinary dividend is taxable notwithstanding that it occurs in a transaction which is in the form of a reorganization. We think that the only question open to review in this connection is whether the Regulations are valid, and we think that they are valid because they reflect an understanding of the statute which has the approval of both the Congress and the courts. Of course, there is a subsidiary question whether the regulations were properly applied to the facts of this case; but since the record supports the Tax Court's finding that there was "no legitimate purpose of the corporate business" in the distribution of the debentures (R. 55), its determination should not be upset on appeal.

The language of the Regulations above quoted was first incorporated in the Regulations under the Revenue Act of 1934 (Treasury Regulations 86, Articles 112 (g)–1 and 112 (g)–2), and as the court below observed (R. 134), the Regulations have remained unchanged in this respect with the passage of succeeding Revenue Acts. The reenactment of the statute as thus construed by the Regulations must, under familiar principles, be regarded as having the approval of Congress. *Helvering* v. *Winmill*, 305 U. S. 79; *Taft* v. *Commissioner*, 304 U. S. 351. The lower court approved these Regulations as reasonable, and a valid exercise of the rule-making power. As it

stated, it would have had to hold the Regulations invalid, in order to reverse the Tax Court, since the recapitalization was not dictated by business exigencies of the corporation, nor was it germane to continuance of the corporate business. (R. 135.) The validity of the Regulations is supported not only by the legislative history of the statutory provisions, but also by the decisions of this Court and the lower courts applying these provisions.

House Report No. 179, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 241, 251) and Senate Report No. 398, 68th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 266, 277) stated in reporting the Revenue Bill of 1924, that the Congressional policy was to exempt from tax the gain on reorganization exchanges so that "ordinary business transactions will not be prevented on account of the provisions of the tax law." Again, in connection with the Revenue Bill of 1934, House Report No. 704, 73d Cong., 2d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 554, 564) stated that—

> * * * the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, "control" being defined as an 80-percent ownership; and

(3) changes in the capital structure or form of organization.

By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time *legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted.* Furthermore, the retention of the other reorganization provisions will prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments. [Italics supplied.]

Senate Report No. 558, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2) 586, 599), is consistent. As the court below pointed out (fn. 12, R. 133), the statutory reorganization and exchange provisions were amended and retained in the 1934 Act, instead of being abolished as a result of attempted abuses, largely because the courts had shown a commendable tendency to look through form to substance, and the amendments were designed to give Congressional approval to such decisions and generally to curtail tax avoidance. See for a full discussion H. Rep. No. 704, 73d Cong., 2d Sess., pp. 12–14 (1939–1 Cum. Bull. (Part 2), 554, 563–565).

A similar restriction was put upon the scope of the reorganization provisions by this Court in

Gregory v. *Helvering*, 293 U. S. 465. In that case a corporation wholly owned by the taxpayer transferred 1,000 shares of stock in another corporation held by it among its assets to a new corporation, which thereupon issued all of its shares to the taxpayer. Within a few days the new corporation was dissolved and was liquidated by the distribution of the 1,000 shares to the taxpayer, who immediately sold them for her individual profit. No other business was transacted, or intended to be transacted, by the new corporation. The whole plan was designed to conform to Section 112 of the Revenue Act of 1928 as a "reorganization," but for the sole purpose of transferring the shares in question to the taxpayer, with a resulting tax liability less than that which would have ensued from a direct transfer by way of dividend. The Court held that while the plan literally conformed to the terms of the statute, there was no reorganization within the intent of the statute. In so holding, this Court took the view that the question for determination was whether what was done, apart from the tax motive, was within the statutory purpose. And in resolving that question in favor of the Commissioner, the Court said (pp. 469–470):

> When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [Sec. 112 (g)] of corporate business; and not a transfer

of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having *no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax

> avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. [Italics supplied.]

As we read the opinion, it holds that whatever may be the tax motive back of a transaction, still, the reorganization provisions of the statute were intended to embrace only operations having a business or corporate purpose and since the *Gregory* transaction showed on its face that there was no such purpose, it was without the intent of the statute.

The *Gregory* case would clearly justify administrative officers in adopting the rule that in order to qualify as a reorganization for tax purposes, a transaction must be induced by a corporate business purpose as distinguished from one to benefit the stockholders individually. And see Paul, *Studies in Federal Taxation*, 3d Series (1940), p. 127; Montgomery, *Federal Taxes on Corporations, Gross Income and Deductions* (1942–1943), p. 218; Fahey, *Income Tax Definition of "Reorganization"*, 39 Col. L. Rev. 933, 937, 969 (1939). Subsequent decisions of this Court are in harmony with that view. Cf. *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, 613–614; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Higgins* v. *Smith*, 308 U. S.

473, 476; *Helvering* v. *Limestone Co.*, 315 U. S. 179, 184–185.

It is true that in *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, the Court, in upholding the Tax Court's conclusion that certain debentures should be treated as such for purposes of the interest deduction, indicated (pp. 525–526) that the *Gregory* case did not prevent that result because the debentures were real and could have been transferred to persons other than stockholders. But here no such question is presented; the issue is not whether the debentures should be accorded full significance as such for purposes of the interest deduction, but whether the reorganization provisions of the law can be brought into operation by a transaction which was the practical equivalent of an ordinary dividend. We submit that they cannot.

The decisions of the circuit courts of appeals sustain the contention that there must be a genuine corporate business purpose. *Electrical Securities Corp.* v. *Commissioner*, 92 F. 2d 593 (C. C. A. 2d); *Helvering* v. *Elkhorn Coal Co.*, 95 F. 2d 732 (C. C. A. 4th), certiorari denied, 305 U. S. 605; *Cogan* v. *Commissioner*, 97 F. 2d 996 (C. C. A. 2d), affirming, *per curiam*, 36 B. T. A. 639; *Black, Starr & Frost-Gorham* v. *United States*, 39 F. Supp. 109 (C. Cls.); *Hendee* v. *Commissioner*, 98 F. 2d 934 (C. C. A. 7th). In cases where it has been found that a statutory re-

organization occurred, the facts indicate that there was a corporate business purpose and the decisions are consistent with our position here. *Okonite Co.* v. *Commissioner*, 155 F. 2d 248 (C. C. A. 3d), certiorari denied, October 28, 1946; *Thermoid Co.* v. *Commissioner*, 155 F. 2d 589 (C. C. A. 3d); *Commissioner* v. *Capento Securities Corp.*, 140 F. 2d 382 (C. C. A. 1st); *Commissioner* v. *Gilmore's Estate*, 130 F. 2d 791 (C. C. A. 3d); *Bass* v. *Commissioner*, 129 F. 2d 300 (C. C. A. 1st); *Commissioner* v. *Kolb*, 100 F. 2d 920 (C. C. A. 9th); *Lea* v. *Commissioner*, 96 F. 2d 55 (C. C. A. 2d); *Coca-Cola Co.* v. *United States*, 47 F. Supp. 109 (C. Cls.); *J. R. Wood & Sons, Inc.* v. *United States*, 46 F. Supp. 277 (C. Cls.).

The Tax Court decisions are also in harmony with our contention. See opinion in the instant case (R. 96–102); also opinion in *Adams* case (*Adams* v. *Commissioner*, 5 T. C. 351, affirmed, 155 F. 2d 246 (C. C. A. 3d), certiorari granted, October 14, 1946, No. 209, present Term, to be argued herewith (*Adams* R. 101–109); *Wellhouse* v. *Commissioner*, 3 T. C. 363; *Annis Furs, Inc.* v. *Commissioner*, 2 T. C. 1096; *Schoo* v. *Commissioner*, 47 B. T. A. 459; *Docherty* v. *Commissioner*, 47 B. T. A. 462; *Fischer* v. *Commissioner*, 46 B. T. A. 999; *Bass* v. *Commissioner*, 45 B. T. A. 1117, reversed, 129 F. 2d 300 (C. C. A. 1st); *Capento Securities Corp.* v. *Commissioner*, 47 B. T. A. 691, affirmed, 140 F. 2d 382.

(C. C. A. 1st); *Hendy* v. *Commissioner*, decided July 24, 1945 (1945 P-H T. C. Memorandum Decisions, par. 45,261), pending on appeal (C. C. A. 7th).

If the principle thus embedded in the Regulations is a valid reflection of the purpose of Congress, then the only remaining question with respect to the application of the reorganization provision is whether the facts of this case disclose a purpose which is germane to the continuance of the business of the corporation or a purpose to promote the individual interests of the stockholders. With respect to such a question the scope of appellate review is limited to whether there is any evidence to support the decision of the Tax Court. *Wilmington Trust Co.* v. *Helvering*, 316 U. S. 164; *Helvering* v. *National Grocery Co.*, 304 U. S. 282, rehearing denied, 305 U. S. 669. The same rule is applied in cases dealing with the question whether transfers were made in contemplation of death. The motive is the critical question in such cases and it has long been the rule that the only question open in the appellate courts is whether there was substantial, or any, evidence to support the decision of the trial court. *McCaughn* v. *Real Estate Co.*, 297 U. S. 606; *Allen* v. *Trust Co. of Georgia*, 326 U. S. 630.

At any rate, it seems clear that since *Dobson* v. *Commissioner*, 320 U. S. 489, this is precisely the kind of question upon which the determina-

tion of the Tax Court is to be final. At this point we are assuming that the principle is settled and that the question is narrowed to whether the facts of this particular case bring it within the principle. The resolution of that question will decide only whether the taxpayer has sustained the burden of proof. *Welch* v. *Helvering*, 290 U. S. 111, 115. Therefore, under the *Dobson* decision, the Tax Court's determination should be accepted as conclusive unless it is arbitrary or unreasonable. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521.

In the instant case the Tax Court specifically found that there was no legitimate corporate business purpose in the distribution of the debentures (R. 95), and its opinion reiterated its findings that there was "a complete absence of legitimate corporate business purpose within the *Gregory* principle" (R. 101). We submit that there is nothing arbitrary or unreasonable about those findings and the Circuit Court of Appeals rightly upheld them. The reasons for the recapitalization are discussed in detail in the findings and opinion of the Tax Court (R. 91–92, 96, 99–101), the opinion of the Circuit Court of Appeals (R. 134–135), and in our brief in opposition to the petition for certiorari (pp. 8–9); and it seems unnecessary to discuss them further here. They do not disclose any purpose germane to the company's business and are consistent with the Tax

Court's factual conclusion, discussed more fully hereinafter, that the bond distribution was in fact a dividend or the substantial equivalent thereof.

The test contended for is not so vague and unworkable as the taxpayer appears to suggest. For example, in *Commissioner* v. *Capento Securities Corp., supra,* the recapitalization was consummated because a bank stipulated it as a condition on which it would extend credit. In *Commissioner* v. *Gilmore's Estate,* 130 F. 2d 791 (C. C. A. 3d), one of the corporate business objectives was the elimination of a holding company. In some cases the corporation desired to obtain stock which it could market (*Bass* v. *Commissioner, supra; Starr* v. *Commissioner,* 82 F. 2d 964 (C. C. A. 4th), certiorari denied, 298 U. S. 680; *Fischer* v. *Commissioner, supra; Haass* v. *Commissioner,* 29 B. T. A. 900, affirmed without opinion, January 14, 1936 (C. C. A. 6th)), and in others the purpose was to eliminate unpaid accumulated dividends on preferred stock so as to improve the corporation's financial standing (*Commissioner* v. *Estate of Bedford,* 325 U. S. 283; *Okonite Co.* v. *Commissioner, supra; Thermoid Co.* v. *Commissioner, supra; Morainville* v. *Commissioner,* 135 F. 2d 201 (C. C. A. 6th); *Shenandoa Rayon Corp.* v. *Commissioner,* 122 F. 2d 268 (C. C. A. 2d), certiorari denied, 314 U. S. 696)). In the *Okonite* case the court distinguished its earlier decision in the instant case by pointing out that the finding of the Tax Court

as to elimination of dividend arrears shows a statement of corporate purpose.

Moreover, it is settled that the mere difficulty in making a finding does not obviate the necessity therefor or the significance of the finding when made. *Helvering* v. *Safe Deposit Co.*, 316 U. S. 56, 66–67; *Cohan* v. *Commissioner*, 39 F. 2d 540, 543–544 (C. C. A. 2d).

The dissenting opinion in the court below (R. 137–140) seems to turn largely upon the difficulty of separating the interests of the corporation from those of its stockholders. But the transaction in the *Gregory* case was certainly intended to be in the stockholder's interest; indeed such was its prime objective; yet the Court held the statute inapplicable because there was no legitimate corporate purpose. While it is true that the general object of a business corporation is to make money for its stockholders, who are in a sense joint adventurers (Berle, *Studies in the Law of Corporation Finance* (1928), p. 20), still, it is also true that there may be a marked conflict of interest as where a stockholder "may hold a large block of stock of the X corporation, and may nevertheless work toward the wreck of the X corporation for some private object of his own." Berle, op. cit., p. 24. In any event, the instant case is not one which it is difficult to classify under the corporate business purpose test. This case hinges simply upon whether the

debenture distribution was in reality a disguised dividend intended solely for the benefit of the stockholders as such and having no connection with the regular business of the company. It is essentially a *Gregory* situation though consummated without the interposition of a new company.

Although the declaration of dividends is an important corporate function, and indeed corporations in some circumstances have been penalized for not exercising it (*Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282), nevertheless, it is certainly not part of the legitimate corporate business to disguise dividends as was done here. If the instant transaction were motivated by such a purpose, and the courts below evidently thought it was, then it would clearly be contrary to the Congressional intention to hold that there was a tax-free reorganization. In any event, we submit that the taxpayer did not sustain the burden of proving such a corporate business purpose as was required to bring the reorganization provisions into operation, and both of the courts below correctly so held.

II

THE DISTRIBUTION OF DEBENTURE BONDS WAS PROPERLY TAXED AS A DIVIDEND

Section 22 (a) of the Internal Revenue Code (Appendix, *infra*) defines in broad and comprehensive terms the income which the taxpayer

must report as his gross income. That income includes "gains, profits, and income * * * growing out of the ownership or use of or interest in such property" or derived "from interest, rent, dividends, securities * * *, or gains or profits and income derived from any source whatever."

Section 115 of the Internal Revenue Code (Appendix, *infra*) covers distributions by corporations. It provides in subdivision (a) that the term "dividend" means any distribution made by a corporation to its stockholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, ~~1913~~ 1913. And in subdivision (b) it is provided that for the purposes of the law every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Subdivision (g) of Section 115 provides that if a corporation cancels or redeems its stock at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend. Subdivision (j) provides that where a dividend is paid in any medium other than money the property received shall be included in gross income at its fair market value.

It seems clear that the debenture distribution involved in the instant case falls squarely within the scope of the statutory provisions above noted. Admittedly, there were earnings and profits accumulated since the organization of the company in 1930 in excess of the fair market value of the debentures. Moreover, we do not understand it to be questioned that if a dividend of the debentures had formally been declared, the amount thereof would have been taxable in the same manner as if paid in cash. *Doerschuck* v. *United States*, 274 Fed. 739 (E. D. N. Y.).

In the circumstances, it is of little importance whether the distribution fell within the scope of subdivision (a) rather than (g). True, there was no formal declaration of a dividend, and the entire transaction was given the form of a reorganization under Section 112 (b) (3) and (g) of the Internal Revenue Code (Appendix, *infra*). But it is settled that it is unnecessary for a dividend to be formally declared in order to be treated as such for tax purposes. Indeed, this Court in effect so held in *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, discussed *infra*, pp. 31–32. See also *Palmer* v. *Commissioner*, 302 U. S. 63, 69; *Chattanooga Sav. Bank* v. *Brewer*, 17 F. 2d 79 (C. C. A. 6th), certiorari denied, 274 U. S. 751; *Hadley* v. *Commissioner*, 36 F. 2d 543 (App. D. C.); *Christopher* v. *Burnet*, 55 F. 2d 527 (App. D. C.); *Fitch* v. *Helvering*, 70 F. 2d 583 (C. C. A. 8th);

Faris v. *Helvering*, 71 F. 2d 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Timberlake* v. *Commissioner*, 132 F. 2d 259 (C. C. A. 4th); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C. C. A. 2d), certiorari denied, 323 U. S. 783; *Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602 (C. C. A. 5th).

Most of the foregoing cases were decided under subdivision (a) or its equivalent in the earlier tax laws, but the rule is the same with respect to subdivision (g). And although there has been some difference of opinion as to the exact basis for the operation of subdivision (g) (see *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C. C. A. 2d), certiorari denied, October 14, 1946; *DeNobili Cigar Co.* v. *Commissioner*, 1 T. C. 673, 678–679, affirmed, 143 F. 2d 436 (C. C. A. 2d)), nevertheless the courts have generally held that the question whether a distribution is essentially equivalent to a taxable dividend is one of fact which depends upon the circumstances in each particular case. *Brown* v. *Commissioner*, 79 F. 2d 73 (C. C. A. 3d); *Commissioner* v. *Champion*, 78 F. 2d 513 (C. C. A. 6th); *Randolph* v. *Commissioner*, 76 F. 2d 472 (C. C. A. 8th); *Hirsch* v. *Commissioner*, 124 F. 2d 24 (C. C. A. 9th); *Commissioner* v. *Babson*, 70 F. 2d 304 (C. C. A. 7th). The Treasury Regulations are in harmony with that view and have long provided that the question whether a distribution in connection with a cancellation or redemption of stock is essen-

tially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. Sec. 19.115–9, Treasury Regulations 103, Appendix, *infra*; Article 115–9, Treasury Regulations 101, 94, and 86. And the latest regulations continue so to provide. See, Section 29.115–9, Treasury Regulations 111.

The objective of Congress is shown by the illustration in the Congressional Committee Reports with respect to Section 201 (g) of the Revenue Act of 1926, in which the provision first came into the law. H. Conference Rep. No. 356, 69th Cong., 1st Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 361), reads in part as follows (pp. 361–362):

> Amendment No. 1: It has been contended that under existing law a corporation, especially one which has only a few stockholders, might without resorting to the device of a stock dividend be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example, assume that two men hold practically all the stock of a corporation for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders for cash one-half of the stock held by them and cancel it without making the stockholders subject to any tax, yet this action in

> all essentials would be the equivalent of a distribution through cash dividends of the earned surplus. Section 201 (g) of the House bill rewrites the provision of the existing law to make clear that such a transaction as above indicated is taxable. Obviously this subdivision does not apply in cases of a complete liquidation of all the stock of the corporation, or to one of a series of distributions in a complete liquidation which is bona fide carried out. This amendment provides that in the case of the cancellation or redemption of stock not issued as a stock dividend this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926; and the House recedes.

See also H. Rep. No. 1, 69th Cong., 1st Sess., p. 5 (1939-1 Cum. Bull. (Part 2) 315, 318); S. Rep. No. 52, 69th Cong., 1st Sess., p. 15 (1939-1 Cum. Bull. (Part 2) 332, 344). We submit that the Circuit Court of Appeals correctly held the instant situation to be within the scope of that illustration. (R. 129–131.)

One of the leading cases is *Flanagan* v. *Helvering*, 116 F. 2d 937 (App. D. C.), where the court pointed out (p. 939) that in determining whether a transaction is equivalent to a taxable dividend under Section 115 (g), there is no sole decisive test; the phrases "in such manner" and "essentially equivalent" negative any idea that a weighted formula can resolve the crucial issue. The court said (pp. 939–940) that

> * * * the net effect of the distribution rather than the motives and plans of the taxpayer or his corporation, is the fundamental question in administering Section 115 (g).

In the circumstances, the court concluded that the Board of Tax Appeals made no error in its determination that the redemption payment was essentially equivalent to the distribution of a taxable dividend. Cf. also *McGuire* v. *Commissioner*, 84 F. 2d 431 (C. C. A. 7th), certiorari denied, 299 U. S. 591; *Smith* v. *United States*, 121 F. 2d 692 (C. C. A. 3d).

As already noted, the Tax Court in the instant case concluded that the debenture distribution was "the equivalent of the declaration of a taxable dividend" (R. 99), and the Circuit Court of Appeals upheld that factual conclusion (R. 129). In the circumstances, we submit that the appellate court could not properly have done anything else, for the record plainly shows that the distribution was made out of earned surplus. *Edwards* v. *Douglas*, 269 U. S. 204, 216–217; *Helvering* v. *Canfield*, 291 U. S. 163; *Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5th), certiorari denied, 323 U. S. 720; *Wilcox* v. *Commissioner*, 137 F. 2d 136, 139 (C. C. A. 9th). There was no liquidation here as there was in *Hellmich* v. *Hellman*, 276 U. S. 233. Here the corporation was a going concern and its capitalization was expanded by transfers from surplus.

And to the extent that the case can thus be reduced to its particular circumstances rather than turn upon a generalizing principle, it would seem that *Dobson* v. *Commissioner*, 320 U. S. 489, is here applicable. Cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, 292.

The net effect of the whole transaction here involved was to leave the shareholders in exactly the same position that they would have been in if the debentures had been distributed in the form of a dividend instead of in the form of a reorganization. It seems clear that, as held by the Circuit Court of Appeals in this case, whatever may have been the motives of the Bazleys, the effect of the distribution was that of a dividend. And cf. *Dutton* v. *Clauson* (D. Maine), decided September 27, 1946 (1946 C. C. H., par. 9354). If the face amount of the debentures had been paid in cash to the stockholders and they had then turned it back to the corporation as payment for debentures which had been issued, there would be no question as to taxability. *Doerschuck* v. *United States*, *supra*. And even assuming, *arguendo*, that there was a real reorganization so far as the exchange of stock is concerned, still, in the circumstances the debentures would have been taxable as a dividend under *Commissioner* v. *Estate of Bedford*, *supra*. There a distribution of cash out of earnings and profits of a corporation, pursuant to a recapitalization which amounted to a statu-

tory reorganization, was held by this Court to have had the effect of the distribution of a taxable dividend within the meaning of Section 112 (c) (2) of the Revenue Act of 1936, which is the same as Section 112 (c)(2) of the Internal Revenue Code (Appendix, *infra*), and to be taxable in full under that section and not as a capital gain under Section 112 (c) (1). We submit that there is not enough difference between that case and the instant one to justify a different result.

Moreover, the *Bedford* case is a complete answer to the taxpayer's contention (Br. 23 ff.) that even if there were no statutory reorganization so that the receipt of the debentures would be tax-free, the income realized on receipt of the debentures must be taxed as a capital gain rather than as a dividend because they were received in an exchange. But even assuming that there were an exchange, that would not prevent the courts from looking through form to substance so as to determine whether a dividend was in fact involved. That, as we understand it, is the rationale of the *Bedford* case and it is also the plain intent of the statute. The decisions of the courts below are in harmony with that view.

There are many instances in the law where it has been necessary to look through form to substance in deciding tax cases. The rationale of such cases is perhaps expressed by the language in *Minnesota Tea Co.* v. *Helvering*, 302 U. S.

609, 613, as follows: "A given result at the end of a straight path is not made a different result because reached by following a devious path."[1] In the instant case the result at the end of a straight path unquestionably would have been an ordinary dividend; and we submit that the result is not changed because a different path was followed.

We are not here contending that the plan of recapitalization should be disregarded, or that the securities issued in pursuance of it are unreal or not valid in accordance with their tenor. Cf. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521. But we do contend that the distribution of debentures under the plan was substantially equivalent to a taxable dividend, and both the courts below correctly so held.

Taxpayer's reliance upon Sections 112 (b) (2) and (c) (1) of the Internal Revenue Code (Appendix, *infra*) is misplaced. He contends in substance that there was an "exchange" of his old stock for new stock and debentures, and that the only possible taxable gain is a capital gain measured by the excess of the value of the debentures over the basis of a proportionate amount

[1] See also *Helvering* v. *Clifford*, 309 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Commissioner* v. *Tower*, 327 U. S. 280; *Lusthaus* v. *Commissioner*, 327 U. S. 293; *Corliss* v. *Bowers*, 281 U. S. 376, 378; *Griffiths* v. *Commissioner*, 308 U. S. 355, 357; *Harrison* v. *Schaffner*, 312 U. S. 579, 581.

of his old stock. (Br. 23 ff.) The crux of his argument is the fact that the Tax Court employed the word "exchange" in describing the transaction, and he therefore seeks to bring this case within the provisions of Section 112 (b) (2) and (c) (1). The fallacy of this position, however, is that the provisions of Section 115 (a) and (g) undercut the provisions of Section 112 (b) (2) and (c) (1). Section 115 (g) speaks of a redemption of stock in such manner as to render the transaction the equivalent to the distribution of a taxable dividend. Obviously such transaction may consist of an "exchange" of securities, and, unless Section 115 (g) be held applicable in such circumstances, its provisions could be nullified. For, every corporation could, in the guise of a recapitalization similar to the one here, distribute its earnings and profits in the form of bonds or other property to its stockholders, who would be taxed on the bonds or other property merely to the extent that they reflect capital gains. This would mean that all the earnings could be distributed in such a manner and thus escape taxation as dividends. It seems clear that Section 115 (a) and (g) must be read as a gloss upon Section 112 (c) (1) to require the taxation as dividends of distributions which are in substance dividends.

The taxpayer cities no authority compelling the holding that a distribution which is in substance a dividend as defined in Section 115 (a)

cannot be so treated under Section 115 (g) merely because it is made in the form of an exchange. Cf. *Commissioner* v. *Estate of Bedford, supra.* Section 115 (g) is obviously not so restricted that it cannot apply to a distribution of property in cancellation of old stock where the distribution is cast in the form of an exchange. The section applies to any cancellation of stock made under such circumstances as to be the equivalent of a dividend. It is not confined to such cancellations as fall within the statutory definition of a partial liquidation. It is immaterial under Section 115 (g) that simultaneously with the cancellation of the old stock a different class of stock was issued. *Hill* v. *Commissioner,* 66 F. 2d 45 (C. C. A. 4th).

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * * *

(2) *Stock for Stock of Same Corporation.*—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) *Stock for Stock on Reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of

the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(c) *Gain From Exchanges Not Solely in Kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

* * * * *

(g) [as amended by Section 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862]. *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected. (26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has

been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

* * * * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 238, inclusive, and, in certain cases, by section 251, for citizens

and domestic corporations derive income from sources within possessions of the United States. Income may be in the form of cash or of property.

* * * * *

SEC. 19.112 (g)-1. *Purpose and scope of exception of reorganization exchanges.*—*Purpose:* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and a continuity of interest therein on the part of those persons who were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation, but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend. * * * In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and pur-

poses must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up..

* * * * * *

The provisions of the Internal Revenue Code referred to in the preceding paragraph of this section are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 112 (g) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme which involves an abrupt departure from normal reorganization procedure, devised and adopted with reference to a transaction on which the imposition of the tax is imminent, is not a plan of reorganization.

SEC. 19.112 (g)–2. *Definition of terms.*—

* * * * * * *

The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 112 (g) (1). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 112 (g) (1), but is to be taken as limiting the nonrecognition of gain or loss

to such exchanges as are directly a part of the transaction specifically described as a reorganization in section 112 (g) (1). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 112 (g) (1), but the readjustments involved in the exchanges effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 112 (g) (1) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

* * * * *

SEC. 19.112 (g)-4. *Exchanges in reorganization for stock or securities and other property or money.*—If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112 (c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent (see section 112 (c)).

* * * * *

If the distribution of such other property or money by or on behalf of a corporation in the course of a reorganization has the effect of the distribution of a taxable dividend, then, as provided in section 112 (c) (2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) as a gain from the exchange of property, the remainder of the gain so recognized.

* * * * *

SEC. 19.112 (g)–5. *Receipt of stock or securities in reorganization without surrender of stock by shareholder.*—Any distribution, though in pursuance of a plan of reorganization, to its shareholders without the surrender of their stock, by or on behalf of a corporation a party to a reorganization, of its stock or securities (other than its own stock, which is not taxable as a dividend under section 115 (f)) or of stock or securities of another corporation a party to the reorganization, shall be taxed to such shareholders as a dividend, within the meaning of section 115, to the extent that the fair market value of such stock or securities at the date of the distribution is not in excess of (1) the earnings or profits of the corporation of the taxable year computed without regard to prior years and (2) the earnings or profits of the corporation accumulated after February 28, 1913, and prior to the taxable year. Any remainder of such fair market value of the stock or securities distributed over the amount of such earnings

or profits shall be applied against and used to reduce the basis provided in section 113 of the stock in respect of which the distribution was made; and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property.

SEC. 19.115–8. *Election of shareholders as to medium of payment.*—If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either (a) in money or any other property or (b) in stock or rights to acquire stock of a class which, if distributed without an election, would not constitute income within the meaning of the sixteenth amendment to the Constitution, then the entire distribution is a taxable dividend regardless of—

(1) whether the distribution is actually made, in whole or in part, in stock or in stock rights which, if distributed without election, would not constitute a taxable dividend;

(2) whether the election is exercised or exercisable before or after the declaration of the distribution; or

(3) whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other. The term "any other property" as used in this section includes stock of the corporation or rights to acquire its stock, of a class which if distributed without an election, would constitute income within the meaning of the sixteenth amendment to the Constitution. (See section 19.115–7.)

SEC. 19.115–9. *Distribution in redemption or cancellation of stock taxable as a*

dividend.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in a complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the

corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

SEC. 19.115–10. *Dividends paid in property.*—If the whole or any part of the dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder. (See section 19.42–3.) Scrip dividends are subject to tax in the year in which the warrants are issued.

SEC. 19.115–11.—*Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—

* * * * *

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1939, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1939, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112 (b) (6) of the Revenue Act of 1936, or of the Revenue Act of 1938, or of the Internal Revenue Code.

(3) The distribution in any taxable year (beginning after December 31, 1938) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as

dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a fax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purpose of this section, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after Decemebr 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936; and for any taxable year beginning after December 31, 1937, and before January 1, 1939, have the meanings assigned to such terms in section 112 of the Revenue Act of 1938.

U. S. GOVERNMENT PRINTING OFFICE: 1940

SUPREME COURT OF THE UNITED STATES

Nos. 287 and 209.—October Term, 1946.

J. Robert Bazley, Petitioner, v. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.
Adam A. Adams, Petitioner, v. Commissioner of Internal Revenue.	On Writ of Certiorari to the Circuit Court of Appeals for the Third Circuit.

287
209

[June 16, 1947.]

Mr. Justice Frankfurter delivered the opinion of the Court.

The proper construction of provisions of the Internal Revenue Code relating to corporate reorganizations is involved in both these cases. Their importance to the Treasury as well as to corporate enterprise led us to grant certiorari, 329 U. S. 695, 329 U. S. 701. While there are differences in detail to which we shall refer, the two cases may be disposed of in one opinion.

In the *Bazley* case, No. 287, the Commissioner of Internal Revenue assessed an income tax deficiency against the taxpayer for the year 1939. Its validity depends on the legal significance of the recapitalization in that year of a family corporation in which the taxpayer and his wife owned all but one of the Company's one thousand shares. These had a par value of $100. Under the plan of reorganization the taxpayer, his wife, and the holder of the additional share were to turn in their old shares and receive in exchange for each old share five new shares

of no par value, but of a stated value of $60, and new debenture bonds, having a total face value of $400,000, payable in ten years but callable at any time. Accordingly, the taxpayer received 3,990 shares of the new stock for the 798 shares of his old holding and debentures in the amount of $319,200. At the time of these transactions the earned surplus of the corporation was $855,783.82.

The Commissioner charged to the taxpayer as income the full value of the debentures. The Tax Court affirmed the Commissioner's determination, against the taxpayer's contention that as a "recapitalization" the transaction was a tax-free "reorganization" and that the debentures were "securities in a corporation a party to a reorganization," "exchanged solely for stock or securities in such corporation" "in pursuance of a plan of reorganization," and as such no gain is recognized for income tax purposes. Internal Revenue Code, §§ 112 (g) (1) (E) and 112 (b) (3). The Tax Court found that the recapitalization had "no legitimate corporate business purpose" and was therefore not a "reorganization" within the statute. The distribution of debentures, it concluded, was a disguised dividend, taxable as earned income under §§ 22 (a) and 115 (a) and (g). 4 T. C. 897. The Circuit Court of Appeals for the Third Circuit, sitting *en banc*, affirmed, two judges dissenting. 155 F. 2d 237.

Unless a transaction is a reorganization contemplated by § 112 (g), any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization" under § 112 (b) (3). While § 112 (g) informs us that "reorganization" means, among other things, "a recapitalization," it does not inform us what "recapitalization" means. "Recapitalization" in connection with the income tax has been part of the revenue laws since 1924. 42 Stat. 227, 230, § 202 (c) (2). Congress has never defined it and the Treasury

Regulations shed only limited light. Treas. Reg. 103, § 19.112 (g). One thing is certain. Congress did not incorporate some technical concept, whether that of accountants or of other specialists, into § 112 (g), assuming that there is agreement among specialists as to the meaning of recapitalization. And so, recapitalization as used in § 112 (g) must draw its meaning from its function in that section. It is one of the forms of reorganization which obtains the privileges afforded by § 112 (g). Therefore, "recapitalization" must be construed with reference to the presuppositions and purpose of § 112 (g). It was not the purpose of the reorganization provision to exempt from payment of a tax what as a practical matter is realized gain. Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain.

These considerations underlie § 112 (g) and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose. Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § 112, in its purpose and particulars, concerns itself. See *Pinellas Ice and Cold Storage Co.* v.

Commissioner, 287 U. S. 462; *Gregory* v. *Helvering*, 293 U. S. 465; *Le Tulle* v. *Scofield*, 308 U. S. 415.

Congress has not attempted a definition of what is recapitalization and we shall follow its example. The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy. Since a recapitalization within the scope of § 112 is an aspect of reorganization, nothing can be a recapitalization for this purpose unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability.

No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. Corporate accounting may represent that correspondence between change in the form of capital structure and essential identity in fact which is of the essence of a transaction relieved from taxation as a reorganization. What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization.

The governing legal rule can hardly be stated more narrowly. To attempt to do so would only challenge astuteness in evading it. And so it is hard to escape the conclusion that whether in a particular case a paper recapitalization is no more than an admissible attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court. See *Dobson* v. *Commissioner*, 320 U. S. 489.

What have we here? No doubt, if the Bazley corporation had issued the debentures to Bazley and his wife without any recapitalization, it would have made a taxable distribution. Instead, these debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account. The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. One does not have to pursue the motives behind actions, even in the more ascertainable forms of purpose, to find, as did the Tax Court, that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income whereas what was done could, with a show of reason, claim the shelter of the immunity of a recapitalization-reorganization.

The Commissioner, the Tax Court and the Circuit Court of Appeals agree that nothing was accomplished that would not have been accomplished by an outright debenture dividend. And since we find no misconception of law on the part of the Tax Court and the Circuit Court of Appeals, whatever may have been their choice of phrasing, their application of the law to the facts of this case must stand. A "reorganization" which is merely a vehicle, however elaborate or elegant, for conveying earnings

from accumulations to the stockholders is not a reorganization under § 112. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. ~~And the facts would equally sus-~~

"And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under Sec. 112 (c) (1) and (2). *Commissioner* v. *Estate of Bedford*, 325 U. S. 283."

~~of gain, but also of other property, or money. . . ." *Commissioner v. Estate of Bedford*, 325 U. S. 283.~~

In the *Adams* case, No. 209, the taxpayer owned all but a few of the 5914 shares of stock outstanding out of an authorized 6000, par value $100. By a plan of reorganization, the authorized capital was reduced by half, to $295,700, divided into 5914 shares of no par value but having a stated value of $50 per share. The 5914 old shares were cancelled and the corporation issued in exchange therefor 5914 shares of the new no-par common stock and 6 per cent 20 year debenture bonds in the principal amount of $295,700. The exchange was made on the basis of one new share of stock and one $50 bond for each old share. The old capital account was debited in the sum of $591,400, a new no-par-capital account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The corporation at this time had accumulated earnings available for distribution in a sum not less than $164,514.82, and this account was left unchanged. At the time of the exchange, the debentures had a value not less than $164,208.82.

The Commissioner determined an income tax deficiency by treating the debenture bonds as a distribution of the corporation's accumulated earnings. The Tax Court sustained the Commissioner's determination, 5 T. C. 351, and the Circuit Court of Appeals affirmed. 155 F. 2d 246. The case is governed by our treatment of the *Bazley*

case. The finding by the Tax Court that the reorganization had no purpose other than to achieve the distribution of the earnings, is unaffected by the bookkeeping detail of leaving the surplus account unaffected. See § 115 (b), and *Commissioner* v. *Wheeler*, 324 U. S. 542, 546.

Other claims raised have been considered but their rejection does not call for discussion.

Judgments affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent in both cases for the reasons stated in the joint dissent of Judges Maris and Goodrich in the court below. *Bazley* v. *Commissioner*, 155 F. 2d 237, 244.

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192

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Supr. Ct

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1946

No. 209

ADAM A. ADAMS, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 18, 1946.

CERTIORARI GRANTED OCTOBER 14, 1946.

Office - Supreme Court, U. S.
FILED
JUN 18 1946
CHARLES ELMORE CROPLEY

IN THE

United States Circuit Court of Appeals

FOR THE THIRD CIRCUIT.

No. 9069.

ADAM A. ADAMS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON APPEAL FROM DECISION OF THE TAX COURT OF THE UNITED STATES.

APPENDIX TO PETITIONER'S BRIEF AND PROCEEDINGS IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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INDEX

	PAGE
Docket Entries	1a
Testimony	3a
Opinion	83a
Opinion	95a
Decision	111a

WITNESSES FOR PETITIONER.

Kurt M. Sinner,	
Direct	7a
Cross	19a
Re-direct	28a, 31a
Re-cross	30a
Adam A. Adams,	
Direct	31a
Cross	35a
Recalled,	
Direct	57a
Cross	58a
Charles F. Kramer,	
Direct	37a
Cross	50a
Re-direct	56a

EXHIBITS.

	Admitted at Page	Printed at Page
P-1—Certificate of Incorporation	8a	
P-2—Minutes of two meetings of Board of Directors and Stockholders of the Newark Theatre Building Corporation	9a	62a
P-3—$100 Par Value Certificates of Capital Stock of the Newark Theatre Building Corporation	11a	
P-4—Certificate	12a	69a
P-5—Bonds	12a	70a
P-6—Certificate of Decrease of Capital Stock	17a	72a
P-7—Balance Sheets	18a	79a
P-8—Balance Sheet	18a	81a
P-9—Photographs	42a	
P-10—Picture	49a	
R-A—Protest	37a	
R-B—Lease	56a	
R-C—Gift Tax Return	60a	
R-E to S—Returns	61a	

Proceedings in the United States Circuit Court of Appeals for the Third Circuit 112a

Order 113a

Opinion of the Court 114a

Judgment 118a

Certificate 119a

Order Allowing Certiorari 119

APPENDIX.

Docket Entries.

1944

Feb.	24.	Petition received and filed. Taxpayer notified. Fee paid.
"	24.	Copy of petition served on General Counsel.
"	24.	Request for Circuit hearing in New York, N. Y., filed by taxpayer. 2/28/44 granted.
Apr.	7.	Answer filed by General Counsel.
"	13.	Copy of answer served on taxpayer. New York City.
Aug.	12.	Hearing set Oct. 2, 1944 at New York.
Oct.	5.	Hearing had before Judge Kern on merits. Briefs due 12/4/44. Replies 12/19/44.
"	9.	Amendment to petition filed by taxpayer. Copy served 10/11/44.
"	25.	Transcript of hearing of 10/5/44 filed.
Dec.	1.	Answer to the amendment to petition filed by General Counsel. Copy served 12/2/44.
"	4.	Brief filed by taxpayer.
"	4.	Motion for extension to Dec. 19, 1944 to file brief filed by General Counsel. 12/5/44 granted.
"	20.	Motion for leave to file the attached brief, brief lodged filed by General Counsel. 12/21/44 granted.
"	22.	Copy of brief served on General Counsel.

1945

Jan.	4.	Motion for extension to Jan. 18, 1945 to file reply brief filed by taxpayer. 1/5/45 granted.
"	4.	Motion for extension to Jan. 22, 1945 to file reply brief filed by General Counsel. 1/5/45 granted.

Docket Entries.

1945

Jan. 17. Reply brief filed by taxpayer. 1/17/45 copy served.

" 22. Reply brief filed by General Counsel. Copy served 1/23/45.

Apr. 26. Findings of fact and opinion rendered Kern J. Decision will be entered under Rule 50. Copies served 4/26/45.

May 1. Order directing the report of Div. 16 promulgated April 26, 1945 be reviewed by the Court entered. Murdock J.

June 29. Findings of fact and opinion rendered Opper J. Decision will be entered for the respondent. 6/29/45 copy served.

" 29. Decision entered Opper J. Div. 14.

Sept. 6. Petition for review by U. S. Circuit Court of Appeals, Third Circuit, filed by taxpayer.

" 7. Notice of filing petition for review sent to J. P. Wenchel filed.

" 7. Proof of service filed.

" 17. Designation of record filed by taxpayer.

" 24. Proof of service of designation of record filed.

Oct. 4. Motion for extension to 11/16/45 to prepare, transmit and deliver the record filed by taxpayer.

" 4. Order extending time to 12/5/45 to prepare, transmit and deliver the record entered.

(Page 1)

Testimony.

Room 5050, 70 East 45th Street,
New York, N. Y,
October 5, 1944 at 2 P. M.

(Met pursuant to notice.)

Before: HONORABLE JOHN W. KERN, Judge.

Appearances:

SYDNEY A. GUTKIN, ESQ., for the Petitioner, 744 Broad Street, Newark, N. J.

JONAS M. SMITH, ESQ. (HONORABLE J. P. WENCHEL, Chief Counsel, Bureau of Internal Revenue), appearing on behalf of the COMMISSIONER OF INTERNAL REVENUE, Respondent.

(Page 2) PROCEEDINGS.

The Court: May I have an opening statement?

Mr. Gutkin: Yes, may it please the Court, the issue in this case, the main issue is comparatively a simple issue. This involves primarily the question of whether or not a recapitalization of the Newark Theatre Building Corporation, a corporation of New Jersey, falls within Section 112B of the Internal Revenue code. During the year 1940, in the month of December in that year, the Newark Theatre Building Corporation for a business purpose necessary in the connection with the affairs of the corporation determined to recapitalize by taking all of the common stock which was $100 par value common stock, the only stock issued as outstanding, cancelling that stock and in place of it issuing no par value common stock and $50 debenture bonds.

Proceedings of October 5, 1944.

Pursuant to the plan of recapitalization, the old common stock was turned in by the stockholders, new common stock and bonds were issued to replace the old common stock. We submit that that transaction was a tax free exchange under Section 112B of Internal Revenue code. This Court has held that it is under exactly similar circumstances as the Docerty case. A secondary issue depending upon whether or not the Court finds that there is not a non-taxable exchange centers around the possibility of so finding, although we submit that there (Page 3) is no probability in the light of the Docerty case. In other words, we submit that if the exchange is a taxable exchange and not governed by Section 112B, that instead of being an exchange upon which gain is recognized, it is an exchange which resulted in a loss, because the fair value of the assets received upon the exchange is less than the cost basis of the stock held by this taxpayer.

In other words, the cost basis of the stock of this taxpayer in the Newark Theatre Building Corporation, which was exchanged for the new stock and bonds is approximately $418,000. The fair value of the property received in exchange for the new stock and the bonds together had a value of between $200,000 and $300,000, so that rather than a gain upon the exchange a loss was incurred.

We also submit that the earnings of profits of the company were not sufficient to result in the amount of dividend that the Commissioner alleges this taxpayer received. There is an error in the computation of the earnings and profits account of the corporation, comparatively slight, but nevertheless to the extent of some $7.000 or so. We submit that under the adjudicated cases of this Court there is no tax to be paid upon the exchange, no gain or loss was recognized, that there was no dividend declared by the corporation and that there should be a decision for the petitioner in accordance with it.

Proceedings of October 5, 1944.

(Page 4) The Court: Mr. Smith.

Mr. Smith: If Your Honor please, respondent contends in this case that the transaction herein did not come within the terms of Section 112B or 112G that what happened was the petitioner in fact received the dividends in the amount of the earnings of the profits that accumulated up to the time that this transaction took place, that debentures which were received were in fact dividends and not a part of the exchange of this transaction and subject to tax to the extent of the value of the accumulated earnings and profits up to the time of this year which is in 1941. We also think that the petitioner in fact did receive a different interest than he had before in view of the fact that after the exchange of stocks for stock he had the debentures of which he could [illegible]est himself at any time he wished and at the same time he would still have all the assets of the corporation as he had before, I mean, since he had practically all the stock, he had practically the entire control of the corporation just as he did before.

I believe that we neglected to mention the fact that the petitioner here owned practically all of the stock of the corporation with the exception of a few shares which I think was owned by his family, therefore, it enured to his benefit. Now, we say also there was no business interest connected with this transaction, that in order for (Page 5) him to meet the requirements of the statute, he must show that there was a business interest in this transaction and we say that there was no such interest in the way we see the case at this time.

Now, with reference to the secondary issues talked about, of course that would be subject to proof as to what the stock of this company was. That respondent has no knowledge at this time except that he believes in accordance with the balance sheets of the corporation that the value of the stock was far in excess instead of below the

amount received by the petitioner. As far as the earnings of profits issue is concerned, petitioner does not seem to have made such an issue in his petition. He cites an alternative issue, but states that the dividend, that is the amount the respondent set up, $164,000., that that dividend really had no value. I take it he means by that it had no value because the stock was in excess of the value of the assets that were received when this transaction took place and I don't see that he has put in issue the fact that accumulated earnings and profits were not in the amount of $164,000. and some odd dollars. I shall of course make my objection to any testimony along that line since as I see it, is not at issue and I am not making that statement at this time so that the petitioner will be put on notice.

The Court: Thank you, suppose we get this matter (Page 6) of the pleadings straightened out first. Upon what allegations of the petition does the petitioner rely on that third issue that was mentioned, Paragraph 4-D at the bottom of Page 2?

Mr. Gutkin: I think, Your Honor, that that would be covered by 4-D on the bottom of Page 2, but I think that if there should be any possibility of any question that it is not covered I should like to make a motion to amend at this time to raise that issue and will submit an amendment in writing.

The Court: You see that paragraph reads in the first phrase, "Also in the alternative, the Commissioner erred in holding that the amount of the dividend, if any, derived through the exchange was in the amount of $164,000. or any value."

Mr. Gutkin: Exactly, sir.

The Court: I take it that the Commissioner has determined that it was in the amount of $164,000.

Mr. Smith: Correct, Your Honor.

Kurt M. Sinner, for Petitioner—Direct.

The Court, Now, petitioner says that the Commissioner erred in determining that it was $164,000. and also alleges that the Commissioner erred in determining that it had any value.

Mr. Smith: That's right.

The Court: So would not the amount of that (Page 7) dividend be an issue under that phrase?

Mr. Smith: It would be an issue as I see it as to a question of value but not as to a question of accumulated earnings and profits. In other words, it seems to me it is tied up with E. The way I read it, the alternative here talking about as two alternatives are the same alternative. It seems to me to be quite ambiguous in that respect.

The Court: Perhaps it would be well for the Petitioner to file an amended petition getting it out a little plainer. I can see if we labor hard we might be able to make an issue here but I think it would be well to have an amended petition.

Mr. Gutkin: Yes, your Honor, I discussed this very thing with Mr. Smith a week or so ago and it is not too great an amount anyway.

The Court: I understand that there are no stipulations of fact.

Mr. Gutkin: No, your Honor, I think on the main issue it will just take a few moments to prove it.

The Court: All right, call your first witness. Whereupon,

KURT M. SINNER, called as a witness on behalf of the petitioner, after having been duly sworn, testified as follows:

(Page 8) *Direct examination by Mr. Gutkin:*

Q. What is your full name? A. Kurt M. Sinner.

Kurt M. Sinner, for Petitioner—Direct.

Q. Where do you reside? A. 1012 Beaver Street, Newark, N. J.

Mr. Gutkin: With the consent of counsel for the respondent I should like to offer in evidence a certified copy of the original certificate of incorporation of the Newark Theatre Building Corporation.

The Court: Accept it into evidence.

(Certified copy of original certificate of incorporation received in evidence and marked Petitioner's Exhibit 1.)

Q. Mr. Sinner, you are a certified public accountant of the State of New Jersey, are you not? A. Yes, sir.

Q. You are the accountant for the Newark Theatre Building Corporation? A. Yes, sir.

Q. And for Mr. Adam A. Adams, petitioner in this cause? A. Yes, sir.

Q. Are you personally acquainted with the events that led up to the redemption of thirty stocks of the Newark Theatre Building Corporation and the issuance of (Page 9) new stock and bonds to replace the old stock? A. Yes, sir.

Q. Were you present at a meeting of the Board of Directors and a meeting of the stockholders of the Newark Theatre Building Corporation on December 6, 1940? A. Yes, sir.

Q. At those meetings was a plan for the recapitalization of the Newark Theatre Building Corporation adopted? A. Yes, sir.

Q. I show you minutes of meeting of Board of Directors of the Newark Theatre Building Corporation, dated December 6, 1940, a waiver of notice of meeting of stockholders of the same corporation, dated the same date and minutes of a special meeting of stockholders of the same

corporation, held on the same date and ask whether these are the original minutes of meetings of the Board of Directors and stockholders of the Newark Theatre Building Corporation, held on December 6, 1940? A. They are.

Mr. Gutkin: With your Honor's permission and with the consent of counsel for the respondent, I should like to offer the minutes of the two meetings in evidence and to substitute for the same a photostatic copy thereof.

Mr. Smith: No objection.

The Court: Accept it into evidence as petitioner's (Page 10) Exhibit 2 and leave granted.

(Minutes received in evidence and marked Petitioner's Exhibit 2 in evidence.)

Q. Mr. Sinner, these meetings of directors and stockholders of the Newark Theatre Building Corporation were the result of certain discussions with respect to a proposed recapitalization of the company, were they not? A. Yes, sir.

Q. You were greatly instrumental in the carrying out of that plan, recapitalization, were you not? A. I was.

Q. You were present at all discussions with respect to the same, were you not? A. Yes, sir.

Q. Would you state what the reasons were for the proposed recapitalization as you know them today? A. Well, there were a number of reasons. One of the first and most pressing reason was that the company was thinking and had been attempting to recapitalize its indebtedness. A mortgage that was on the building 193, 195 Market Street and Beaver Street were originally contracted when Mr. Adam A. Adams and Mr. Peter Adams personally had titles and both Mr. Peter Adams and Mr. Adam A. Adams were on the bond. After the separation of interests between Mr.

Peter Adams and Mr. Adam A. Adams, (Page 11) in 1939, Mr. Peter Adams had repeatedly requested that he be taken off the bond, in other words, that his liability on the bond be taken off. However, the mortgagee would not——

Mr. Smith: Were you present when Mr. Peter Adams made that request you are talking of?

The Witness: I beg your pardon?

Mr. Smith: Are you talking about what someone else said?

The Witness: No, I was there.

Mr. Smith: You were there?

The Witness: Yes.

Q. Will you continue, please? A. Mr. Adam A. Adams had prior to this time attempted a number of times to negotiate a new loan. He had not been successful. We thought at the time that an additional collateral might be required and that it might be easier to place as collateral for loans a ceiling or number of debentures or an instrument of obligation rather than the common stock of the company which in itself nobody seemed to want to take as collateral.

Q. When you speak of, we thought that we would be able to use bonds more easily than stock, do you refer to the corporation or any of the individuals? A. The directors of the corporation and myself. I was there at all the discussions. I entered into them. (Page 12) I am not a stockholder, but being the accountant of the company, I was naturally consulted in these matters.

Q. And the directors acting on behalf of any of the individuals or acting on behalf of the corporation? A. On behalf of the corporation. A secondary consideration, there was the capital structure which had outstanding 5,914 par value shares and by reducing that under the New Jersey franchise taxes we would have $400 and some odd dollars

per year. That was one of the factors that I took into consideration.

Q. Were there any other reasons? A. Yes, there would also be income tax savings in doing this.

Q. I show you certain papers which purport to be shares of capital stock of the Newark Theatre Building Corporation, stating that it has a capital stock of $600,000, the certificate having a stamp on it that the shares are $100 each and ask whether these are the certificates formerly held by the stockholders of the corporation prior to the reorganization of the corporation? A. They are sir.

Mr. Gutkin: With consent of counsel for the respondent, I wish to offer in evidence the $100 par value certificates of capital stock of the Newark Theatre Building Corporation which had been redeemed by the stockholders (Page 13) thereof.

The Court: Let it be received in evidence.

Certificates received in evidence and marked Petitioner's Exhibit No. 3 in evidence.)

Q. Referring to the plan of reorganization, what did the plan require that the stockholders do? A. I know what the plan was.

Q. You may state it if you don't need anything to refresh your recollection? A. It required the stockholders to turn in their certificates of $100 par value in exchange for a certificate no par value with a stated value of $50 and a debenture of $50.

Q. According to the books of the corporation, how many shares of $100 par value stock were held by Mr. Adam A. Adams in December, 1940, upon the adoption of the plan of reorganization? A. 5,903.

Q. What did Mr. Adams do with these shares if you know of your own knowledge? A. Yes, he brought in his shares in my office and I issued to him and to the other

stockholders new certificates, that is, I wrote them out and they were signed by the proper officer, new certificates and debentures of the type called for. This was on January 27, 1941.

(Page 14) Q. Was the plan carried out in exact accordance with the terms? A. Yes, sir.

Mr. Gutkin: With consent of counsel for the respondent I offer in evidence a certificate numbers 3, 4, 5, 903 shares* of the Newark Theatre Building Corporation, issued to Adam A. Adams, bearing date January 27, 1941, and ask your Honor's permission to withdraw the same and to substitute in place thereof photostatic copy.

The Court: Let it be received in evidence, leave granted.

(Certificate received in evidence and marked Petitioner's Exhibit No. 4 in evidence.)

Mr. Gutkin: Also with consent of counsel for the respondent I offer in evidence one of the bonds issued to Mr. Adam A. Adams in accordance with the plan of liquidation for the purpose of indicating that the type of bond that was issued in connection with the plan and ask leave to withdraw the same and substitute a photostatic copy thereof.

The Court: Admitted in evidence and leave granted.

(Bonds received in evidence and marked Petitioner's Exhibit 5 in evidence.)

Q. Mr. Sinner, have you made an analysis of the (Page 15) surplus or the earnings of profits account of the Newark Theatre Building Corporation as it was on January 27, 1941? A. Yes, sir.

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*Corrected: certificate number 3 for 5903 shares.

Kurt M. Sinner, for Petitioner—Direct.

Q. Were the books and records of the corporation kept under your supervision and control? A. Yes, sir.

Q. You are familiar with the books and records of the corporation? A. Yes, sir, I am.

Q. You have them in court with you? A. Yes, sir.

Q. Have you any paper which you might use to refresh your recollection with respect to the earnings or profit accounts, so that we might be able to expedite the development of the accumulated earnings or profits of the corporation? A. Yes, sir.

Q. Referring to the records of the corporation, will you state what the earnings or profits of the corporation accumulated as of January 27, 1941?

Mr. Smith: I object to that, that is a conclusion. If he is going to find out what that is he has to go through that right from the beginning right up to what it was and I object to his stating what it was as a conclusion.

The Court: Is this question as to what the books show it to have been?

(Page 16) Mr. Gutkin: Yes, your Honor.

The Court: I will overrule the objection, he can answer. What do the books show the earnings or profits to have been?

The Witness: On January 2, 1941, the accumulated earnings or profits in the surplus account show $45,629.05.

Q. In the history of the corporation there had been some earnings or profits that had been capitalized in prior years? A. Yes, sir.

Q. What was the amount of earnings or profits that you had capitalized in prior years? A. $111,596.

Kurt M. Sinner, for Petitioner—Direct.

Q. Now, Mr. Sinner, referring to the books and records which might indicate what Mr. Adams' cost basis for his stock of the corporation was, would you take those books and records and develop for us Mr. Adams' cost basis of his stock? A. Prior to January 1, 1928, Mr. Adam A. Adams and Mr. Peter Adams operated two theatres, one in Paterson, N. J. and one in Newark, N. J. and also owned other realty, all of which was carried on as partners.

On January 1, 1928, there were formed five corporations, the Newark Theatre Building Corporation, which acquired from the partners the theatre building and sundry (Page 17) other assets; the Alpha Pi Realty Corporation, which acquired certain other commercial buildings in Newark; The Newark Theatre Amusement Corporation; which acquired title to the fixtures in the theatre; the U. S. Theatre Corporation which acquired title to the theatre building in Patterson and the lease to the land and operated the U. S. Theatre and the Adams Brothers Realty Corporation, which acquired the other commercial buildings in the City of Patterson, the partners being even. Their holdings with the exception of qualifying shares were equally split on date of incorporation.

Now, those costs, I have gone through the old records, those costs I have determined several years ago. It was necessary for me to find out about those things and several years ago I made an analysis. I have some sheets with me that I made up at that time,

Q. If they will refresh your recollection you may refer to them and testify therefrom.

Mr. Smith: Now, if your Honor please, I object to his testifying as to what the cost was from any sheets he may have.

The Court: While looking at this memorandum you are able to follow through step by step your calculations and tell the Court?

The Witness: Yes.

(Page 18) The Court: The question is not to give one final sum, but you are going to get from this witness the various steps he took working from the books?

Mr. Gutkin: Yes, we have the books present and I wish the record would show Mr. Sinner is referring to those books where necessary.

Mr. Smith: You overrule my objection, I take it?

The Court: Yes.

Mr. Smith: I take an exception.

The Court: Exception noted.

Q. These are the books of original entry, are they not? A. Yes, these are the books of the various companies involved.

Q. In the statement you just made? A. Yes.

Q. And are they books of original entry kept in the ordinary course of business of the various companies and concerns that you mentioned? A. Yes, sir.

Q. And these sheets that you are referring to to refresh your recollection are sheets made up by referring to these books? A. They were made up by me by going through these books, yes, sir.

(Page 19) Q. And they are in exact accord with the books? A. Yes, sir.

Mr. Smith: What books are those that you are referring to?

The Witness: Of all the various companies that I mentioned.

Mr. Smith: And are you also referring to the books of the partnership, did they have books?

The Witness: Yes, sir, they are here too.

The Court: Go ahead, sir.

Kurt M. Sinner, for Petitioner—Direct.

Q. Would you kindly continue with your development of the cost basis and give each item thereof and then try to arrive at a total cost basis for all of the stock held by Mr. Adams at the date of the adoption of the plan of recapitalization and when he exchanged his old stock for new stock and bonds? A. The amount that was transferred from the Patterson partnership to the corporations that were operating in Patterson, Mr. Adam A. Adams' share was $207,547.82. In the three Newark corporations, the investment at cost as determined by me was $192,379.97. That includes, however the cost of all the shares issued for Mr. Adam A. Adams. In addition thereto, there was issued in the U. S. Theatre Amusement Corporation during 1928 fifteen shares for which Mr. Adam A. Adams had invested cash. During the (Page 20) year, I think it is 1931, on audit by the Internal Revenue Department, of both the Newark and Patterson properties, the revenue agents made certain adjustment to the depreciation as basis of cost for years prior to December 31, 1927 as a result of which the corrections as of January 31, 1928, involved $1,822.72 in Patterson, in the U. S. Theatre and $8,656.88 in Newark. That is Mr. Adam A. Adams' portion of the adjustment. Subsequently, when the Newark Theatre Amusement Company went out of existence in 1931, the two Adams brothers had cash loans there which they never got back, which is an additional investment. Mr. Adam A. Adams' sum is $6,812.50. That would give us a total cost of $418,719.09 for the final 5,914 shares. However, on the date of January 27, 1941, Mr. Adam A. Adams held 5,903, so if I take a fraction of that that makes the cost of the 5,903 shares $417,944.28, to which must be added the four dollars which he paid in 1938 for a fractional part of a share upon the issuance of the last stock dividend. Now, I just stated that there were formed five corporations in 1928. In 1932, due to a series of non-taxable stock exchanges, the

company, filed consolidated returns. In 1935, Mr. Peter Adams and Mr. Adam A. Adams wanted to separate their interests and Mr. Peter Adams took the Patterson companies and Mr. Adam A. Adams took the Newark companies. Subsequent to that in 1936, one of the Newark companies was (Page 21) not in existence then, the Newark Theatre Amusement Corp. In 1936, the properties of the Alpha Pi Realty Company were sold at cost to the Newark Theatre Amusement Corporation, so therefore all of Mr. Adams' holdings are now vested in the Newark Theatre Building Corporation, the cost of which still remains the same as it was in 1927, with the exception of the additions that I have mentioned.

Q. The total amount that you mentioned does that represent the interest to Mr. Adam A. Adams of his 5,903 shares of $100 par value stock of the Newark Theatre building Corporation? A. Yes, sir.

Q. And that amount would you repeat? A. $417,944.28.

Mr. Gutkin: With consent of counsel for the respondent I offer in evidence a certified copy of a certificate of decrease of capital stock and amendment of the certificate of incorporation of the Newark Theatre Building Corporation, pursuant to the plan of reorganization thereof.

The Court: Which will be received.

(Certified copy of certificate of decrease of capital stock and amendment of certificate of incorporation received in evidence and marked petitioner's Exhibit 6 in evidence.)

(Page 22) Q. Mr. Sinner, I show you a paper which purports to be the balance sheet of the Newark Theatre Building Corporation as at December 31, 1940, and ask whether you prepared the same and whether this is a true

and correct balance sheet of the assets and liabilities of that corporation as of that date? A. It is.

Mr. Gutkin: I ask your Honor that it be marked in evidence.

The Court: No objection?

Mr. Smith: Are these the balance sheets?

Mr. Gutkin: Yes, sir.

Mr. Smith: Are these made up by you from the books?

The Witness: Yes, sir.

Mr. Smith: No objection.

The Court: Accept that in evidence.

(Balance sheets received in evidence and marked Petitioner's Exhibit No. 7 in evidence.)

Q. I show you a paper which purports to be the balance sheet of the Newark Theatre Building Corporation, as of December 31, 1941, and ask whether or not you prepared the same and whether it shows the assets and liabilities of the corporation as of that date? (Page 23). A. Yes.

Mr. Gutkin: I ask that it be marked in evidence.

Mr. Smith: No objection.

The Court: Accept that in evidence.

(Balance sheet received in evidence and marked Petitioner's Exhibit No. 8 in evidence.)

Q. Referring to the books and records of the corporation, the Newark Theatre Building Corporation, how was the exchange pursuant to the plan treated on the books with respect to the capital and surplus account? A. The surplus was not affected at all. We debited the old par capital stock for the sum of $591,400. and credited the new no par value stock of $295,700. and credited the rest to an obligation or indebtedness called debentures $295,700.

Kurt M. Sinner, for Petitioner—Cross.

Q. As a result of the exchange did you make any entries or changes with respect to the surplus account? A. No, sir, there was not any intent to take anything out of surplus.

Q. At the time the plan of reorganization was discussed, was there any intent or purpose to declare a dividend? A. No, sir.

Mr. Gutkin: You may cross examine.

(Page 24) *Cross examination by Mr. Smith:*

Q. Mr. Sinner, I believe you stated on direct examination that the purpose of exchanging the 5,000, whatever number it was, 5,903 shares of stock of $100 par value for no par value of stock and for debentures was because there was a number of loans outstanding? A. No, an open mortgage outstanding.

Q. An open mortgage? A. Yes, sir.

Q. And what did you propose to accomplish by that? A. Well, the thought in mind was that if the mortgage itself would not give sufficient security, we might have to borrow money, whether Mr. Adams borrowed it personally or whether the corporation could borrow it and give therefore as collateral either stock or debentures, and we thought it would be easier to borrow on the strength of debentures rather than on the strength of common stock.

Q. What was the basis for that? A. I don't follow that.

Q. What was the basis for thinking that debentures were easier to borrow on than stock? A. Well, that was the thought we had.

Q. You mean by "we" you are talking about now, the Newark Theatre Building Corporation, that is the stock we are talking about? (Page 25) A. Yes.

Q. So that when you refer to "we" you mean that? A. I mean their directors and myself.

Q. Well, in your minutes you state that the whole capital structure of the company was not well balanced and it was not sound business to have some topheavy capital setup? A. Yes.

Q. You also stated that your purpose was to save about $400 in franchise taxes? A. Yes.

Q. How much did it cost to make this transfer over, how many fees were paid by the corporation? A. I can identify the bills right here. There is a bill paid early in that year, February 5th, $170.30 and there is another one paid in June.

Q. Who acted as attorney in this transaction, do you know? A. Yes, sir.

Q. Who was that? A. The office of Arthur T. Vanderbilt, Newark.

Q. And how much did he charge, how much was paid to him during that year as fees?

Mr. Gutkin: With respect to this transaction of course?

(Page 26) Mr. Smith: That's correct.

Mr. Witness: On February 5th, $170.30 and on June 12th, $589.14.

Q. That was all that was paid? A. Yes, sir.

Q. Now, you also stated that one of the purposes was the saving of income taxes, did you not? A. Yes, sir.

Q. Wasn't that the principal purpose? A. No, it was not the principal purpose.

Q. Well, as a matter of fact you saved a great deal more in income taxes than you did in franchise taxes? A. Yes.

Q. How much did you save in income taxes that one year? A. I haven't made a calculation as to that.

Kurt M. Sinner, for Petitioner—Cross.

Q. You don't know as to that? A. I don't know but I could make a calculation.

Q. Now, as a result of having debentures in place of stock, you of course were able to deduct interest that you were not able to deduct before? A. Yes.

Q. So that as to that extent there was a saving in income taxes? A. Yes.

(Page 27) Q. And whatever that saving was in 1941, 1942 and 1943, would be a part of the savings here in income taxes? A. I didn't follow that.

Q. Whatever the interest that was deducted for these bonds in 1941, 1942 and 1943, would be part of the savings for these years, if not all, would it not, for the corporation? A. Yes, sir.

Q. And then do you know whether or not the debentures were ever made as gifts by Mr. Adam A. Adams, the Petitioner here, to his children? A. I do, sir.

Q. Wasn't that one of the reasons for this transaction in order to make these gifts? A. I know that, this has nothing to do with the corporation but I will give you the answer. I know that Mr. Adams has it in mind or had it in mind to give some of his certificates and debentures and otherwise to give it to members of his family as they were growing older.

Q. Now, you have very rapidly come to the conclusion that the cost of this stock 5,093 shares* of the Newark Theatre Building Corporation was $417,904.28 to this petitioner? A. $417,944.28.

Q. And you have done that by rapid calculation? (Page 28) A. I didn't do it here.

Q. But that is the figure you have given us? A. That is the final figure I arrived at, yes.

Q. This corporation was founded when, January 1, 1928? A. Yes, sir.

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* Corrected: 5903 shares.

Kurt M. Sinnyr, for Petitioner—Cross.

Q. At that time, how many shares of stock did the petitioner, that is, Mr. Adam A. Adams acquire of the Newark Theatre Building Corporation? A. 1,000 shares.

Q. 1,000 shares? A. Yes, sir.

Q. Of this stock the 1,000 shares were acquired on January 1, 1928 for him? A. Yes, sir.

Q. Now, what was that acquired for, what was given for that stock? I mean, what was that stock for, in lieu of what? A. The building that belonged to the partnership.

Q. The building that belonged to the partnership? A. That's correct.

Q. Now, when did the partnership acquire the building? A. I think it was in 1921.

Q. And how much did the partnership pay for the building? (Page 29) A. Land and building $937,000.

Q. $937,000? A. Yes, sir.

Q. And that is what was acquired by that corporation? A. Yes.

Q. Now, how many shares of stock was issued by the corporation on January 21, 1928? A. 2,000 shares.

Q. 2,000 shares? A. Yes, sir.

Q. Now, who received the other 1,000 shares? A. Mr. Peter Adams.

Q. Mr. Peter Adams? A. Yes.

Q. Now, was there not 5,000 shares issued on January 21, 1928? A. No, sir, it was not only the building, there are cash supplies and other stuff transferred here too.

Q. Well, I show you what purports to be the 1928 income tax return of the Newark Theatre Building Corporation for 1928 and you will note on here it says, 500,000, wouldn't that show that 500,000 shares of stock were issued? A. You are right, I was testifying from the books of Newark Theatre Amusement Corporation.

Q. In other words, you were not testifying from the (Page 30) correct books? A. That's right.

Kurt M. Sinner, for Petitioner—Cross.

Q. So then let us get this straight now, how many shares of stock were issued to Adam A. Adams on January 1, 1928 on the Newark Theatre Building Corporation stock, which is the stock we have in issue here? A. 2,500.

Q. 2,500 were issued to him? A. Yes.

Q. And that was one-half of the total issue? A. Yes, sir.

Q. Now, when were the next shares issued to Mr. Adam A. Adams, the next shares of the Newark Theatre Building Corporation? A. The next thing that happened was on January 31, 1932, there were 628 shares of Mr. Adam A. Adams' stock cancelled and put back into treasury stock in order to take off the books the appreciation that had been placed hereon on date of incorporation.

Q. How many shares were taken off? A. 628.

Q. 628 of this gentleman? A. 628 of Mr. Adam A. Adams and the same amount from Mr. Peter Adams.

Q. So that left him on January 1, 1933, with how (Page 31) many shares? A. He had 1,872 shares.

Q. Well, he only had 2,500 in the first place and you say 628 off? A. That's right.

Q. Now, when were the next shares issued? A. On January 9, 1932, there were issued 383 shares in exchange for the same number of shares of Newark Theatre Amusement Company stock.

Q. In exchange for Newark Theatre Amusement Company? A. That's right, on the same date——

Q. This is to Adam A. Adams, the petitioner? A. Yes.

Q. All right, go ahead. A. On the same date, 1,400 shares were exchanged for 2,800 shares of Newark Theatre Amusement Corporation.

Q. He acquired 1,400 more for what? A. For 2,800 shares of Newark Theatre Amusement Corporation.

Q. Well now, in making the valuation here, did you go into the assets held by the Newark Theatre Amusement

Corporation? A. I did make a calcu..ion for myself as to what the costs would be under these exchanges, but in the final analysis it comes down to the same thing, what this cost (Page 32) in Patterson and Newark were finally wound up in the Newark Theatre Building Corporation.

Q. But you didn't know what it cost the Newark Theatre Amusement Corporation, the first was 383 shares for what? A. Newark Theatre Amusement Corporation.

Q. You don't know the cost basis for that? A. Yes, sir.

Q. You had made no analysis of that? A. Yes, I have, because the Newark Theatre Amusement Theatre Corporation got their assets from the partnership too on the same date, January 1, 1928.

Q. Oh, I see, there were five corporations formed again from this partnership, is that correct? A. Yes, sir.

Q. And the 1,400 shares were exchanged for 2,800 shares of Newark Theatre Amusement Corporation, that is another one of the five corporations? A. That's right.

Q. Now, how many shares did Mr. Adam A. Adams hold at that time? A. 2,955 which included one qualifying share. On June 13, 1935, Mr. Adams exchanged 89 shares for 39 shares of U. S. Theatre Amusement Corporation and 50 shares of Adams Brothers Realty Company.

(Page 33) Q. Well now, the last two companies, what are the names of them? A. U. S. Theatre Amusement Corporation.

Q. And the other? A. Adams Brothers Realty Company.

Q. Were they formed from the partnership too? A. Yes.

Q. How many shares did he hold then at this stage? A. 3,044.

Q. All right now, what is the next transaction? A. July, 1936, 1,754 shares for 588 shares of Newark Theatre Amusement Corporation, that makes 4,798.

Q. What was the date of that? A. July 31st I think, 1936.

Q. And how many shares did he have at this time? A. I think that it is at this point, now just prior to that on June 13, 1935, he gave to his wife ten shares, which left him with 5,788 including Mr. D'Arcy's qualifying share.

Q. Now, what was the next acquisition? A. December 31, 1936, the stock dividend of 1,000 shares.

Q. Stock dividend declared by the Newark Theatre Building Corporation? A. Yes, sir.

(Page 34) Q. And does that make the total that we got set up here? A. 5,788 you have now. On October 19, 1938, there was a 2 per cent stock dividend of $115.96,* and at the same date the purchase of .04 share for the sum of $4 in cash, which brings us down to 5,904 shares. The one share was sold in 1939 I think or thereabouts or 1940 to Thomas Adams.

Q. In 1931, was there not issued $76,500 worth par value stock for theatre equipment? A. I think there was on March 31st.

Q. There was how much issued? A. $76,500.

Q. And was some of those shares of stock issued to the petitioner? A. No.

Q. None issued to the petitioner? A. No.

Q. Who were they issued to? A. The Newark Theatre Amusement Corporation.

Q. Now, how much depreciation was carried over from the partnership to the Newark Theatre Building Corporation on the books? A. None, it was taken at a net value.

Q. In other words, you did not carry over any de-
(Page 35). preciation of partnership over into the corporation, is that right? A. Not on January 1, 1928. Subsequently, however, through Government audit the adjustments were reflected after conferences I believe, they were

* Corrected: stock dividend of 115.96 shares.

reflected and the adjustments were made in 1932 when this stock was cancelled in order to take care of the difference.

Q. Do you know that as a fact? Do your books reflect that? A. An entry made to that extent?

Q. Yes. A. Yes, sir.

Q. Do you have there the reserve for depreciation account of the Newark Theatre Building Corporation? A. Yes, sir.

Q. For all years 1928 to 1941 inclusive? A. I think so.

Q. How many pages does it consist of? A. About six or seven pages.

Mr. Smith: Your Honor, I would like to offer in evidence the reserve for depreciation account of this corporation, in order to show that this $110,000 had never been properly reflected and in addition should be taken into consideration in arriving at the amount of basis in this case.

(Page 36) The Court: Could counsel perhaps stipulate what the books show with regard to the depreciation account?

Mr. Gutkin: If your Honor please, I don't think that what the depreciation account of Newark Theatre Building Corporation has or has not is material. However, I have no objection to trying to ascertain exactly the facts that Mr. Smith is trying to arrive at.

The Court We will take a recess at this time. Perhaps counsel can work out a stipulation.

(At this time a short recess was taken.)

Mr. Smith: If your Honor please, we have not been able to agree on those books, and I am going to withdraw my request or proposal to put that in as an exhibit. In lieu thereof, I shall put in some of these returns to bring out the point I shall make.

The Court: All right.

Q. Now, Mr. Sinner, I believe you testified that the earned surplus of Newark Theatre Building Corporation on January 1, 1944, was $44,269.40, is that correct? A. $45,629.05.

Q. All right now, the stock as a result of non-taxable dividends in prior years, what was that? A. $111,596.

Q. Now, what were the undistributed earnings of the calendar year 1941 of the Newark Theatre Building Cor-
(Page 37) poration? A. The undistributed earnings?

Q. Yes. A. Well, there is a profit for the year $16,520.42, out of which a dividend was declared $8,871, leaving undistributed $7,649.42 for that year.

Q. That should have been included as part of the accumulated earnings, shouldn't it? A. That would be the addition for that year.

Q. For that year? A. Yes, of course, there are in addition to that two surplus adjustments for additional income taxes for prior years.

Q. Now, I want to ask a question about the genesis for your basis of ascertaining the cost in this case. I believe you testified that the cost of the land and buildings of the partnership was $937,000? A. I think it is, I think that is what it said on the books here.

Q. Now, how much did Adam A. Adams pay into that, how much was the cost to him, to Adam A. Adams, the petitioner of that $937,000, what was his cost? A. It would be half of that.

Q. What is that? A. It would have been half of that.

(Page 38) Q. How do you know? A. That is what the books show.

Q. That is what the books show? A. Yes.

Q. Now, was that amount paid by Adam A. Adams in cash? A. No money.

Q. How was it paid? A. It was some cash and some mortgage.

Q. All right, give us the details of how it was, how much was cash and how much was mortgage? A. The detail of what you are asking me now, you mean the date of acquisition?

Q. Yes. A. I don't have it with me.

Q. You don't know what the cost was to Adam A. Adams when this property was acquired, do you? A. Yes, in 1924 when these books were opened we did find the cost and we did find what he still owed on it.

Q. But you don't know how that was paid, do you? A. Well, my memory does not serve me, I will probably have papers in my office to show how I arrived at it.

Q. You don't know whether it was paid by cash, to what extent or to what extent was paid by stock? (Page 39) A. Originally, I don't remember, no, sir.

Mr. Smith: No further questions.

Re-direct examination by Mr. Gutkin:

Q. Mr. Sinner, do the books that you have here assist you in arriving at the cost to Mr. Adams of the stock of the Newark Theatre Building Corporation in so far as his cash and other property contribution to the Newark Theatre Building Corporation? A. Yes, the books reflect all assessments.

Q. Are you able to state how much of cash and how much of other property, or are you only able to state the total as shown on the books? A. Well, the books would reflect the opening entry as of January 1, 1928, which consists of cash, other property and so forth, property stated at that time as an appreciated value, I stated that before. Subsequent to audit by the Government at conference they arrived at values and the adjustment was reflected on the

books of the Newark Theatre Building Corporation in 1932. The same thing was done in Patterson, the U. S. Theatre, in fact there was a case before the Tax Court which finally fixed the valuation of that building, I think that is in 1931, I am not sure but I think so.

Q. What does your opening entry show as to Mr. Adam (Page 40) A. Adams' cost for his stock in this corporation? A. The opening entry did not reflect absolute cost when it was adjusted.

Q. What was the entry? A. The opening entry showed cash $4,378.25, unexpired insurance $1,963.42, real estate and $500,000 real estate buildings and additions $570,000. Against that the credits are mortgage interest accrued $1,341.67, mortgage payable $575,000, common stock issued $500,000.

Q. What according to the books was the total contribution of stockholders to the corporation? A. According to that entry it was $500,000. It was subsequently amended in January, 1932.

Q. What was the result of that amendment or readjustment? A. $125,600 of treasury stock received in order to cancel out $125,665. of appreciation. The adjustment and surplus is $65.

Q. So that after you readjusted the accounts for an amount of appreciation as was set up on the books, what would books indicate as Mr. Adams' cost? A. Originally you are talking about in 1928?

Q. Yes. A. $134,612.54.

Q. And that the other parts of his costs were as (Page 41) testified by you earlier as to the amounts paid on the subsequent issuance of stock? A. Yes, sir, and his other costs are the investments in these other companies.

Q. And the total was how much? A. The total including the other eleven shares was $418,719.09.

Kurt M. Sinner, for Petitioner—Re-cross.

Q. And the cost of the 5,903 shares? A. $417,944.28, taking into consideration the four dollars.

Q. On December 6, 1940, how many shares of stock were issued and outstanding? A. 5,914.

Q. On January 27, 1941, immediately prior to the exchange how many shares were issued and outstanding? A. 5,914.

Q. On both of those dates how many shares did Mr. Adams own? A. 5,903.

Q. You stated an amount of fees paid to the office of Arthur T. Vanderbilt in the year 1941? A. I didn't say that. He asked with respect to this transaction.

Q. With respect to this transaction? A. Yes, sir.

Q. You also were asked whether the total savings in franchise taxes was $400. (Page 42) A. $400 and some odd dollars, I can tell you the amount exactly if you want it.

Q. Would that have been per year or all together? A. Per year.

Q. In other words, every year of the existence of the corporation that amount would be saved, is that correct? A. That's right. You want the exact amount?

Q. All right, will you state the exact amount? A. $413.98 per year.

Q. Each and every year of the corporation's existence? A. Yes, sir.

Q. In cross examining, it was stated that you had just computed the cost basis. How long a time did it take you to recompute Mr. Adams' cost basis? A. A couple of weeks.

Mr. Gutkin: No further questions.

Re-cross examination by Mr. Smith:

Q. Mr. Sinner, when you are talking about entries there in books, you are talking about entries in the books of the

Newark Theatre Building Corporation, aren't you? A. Yes.

Q. And the answers you have given to these various questions of counsel for the petitioner are referring to those books? (Page 43) A. Yes.

Q. And the costs set up in the books of the Newark Theatre Building Corporation? A. Yes.

Mr. Smith: No further questions.

Re-direct examination by Mr. Gutkin:

Q. So far as you know of your own knowledge do these books truthfully and accurately represent the actual amounts as set forth therein? A. I didn't follow that question.

Q. Are the books true and correct reproductions of actual transactions that occurred as at the time of the entry? A. Yes.

Q. And they were kept in the ordinary course of business of the Newark Theatre Building Corporation? A. Yes, sir.

Mr. Gutkin: No further questions.

The Court: That is all, sir.

Whereupon,

ADAM A. ADAMS,

called as a witness on behalf of the petitioner, after having been duly sworn testified as follows:

Direct examination (Page 44) *by Mr. Gutkin:*

Q. What is your full name? A. Adam A. Adams.

Q. Where do you reside? A. 251 Elmwind Drive, Orange, N. J.

Q. Mr. Adams, you are the petitioner in this court, are you not? A. Yes, sir.

Q. You are familiar with the events leading up to the recapitalization that Mr. Sinner testified to? A. Yes, sir.

Q. You heard Mr. Sinner's testimony? A. Yes, sir.

Q. What were the reasons that led to the recapitalization? A. Up to 1935 my brother and I, Mr. Peter Adams, [redacted] were on a bond, on a mortgage to the Prudential Insurance Company, another bond to the Fidelity Union Trust Company. We got a loan way back in 1924 of the Prudential Insurance Company for the Prudential Insurance Company to grant that loan that existed that both Mr. Peter Adams and I be guarantors to that bond which we did. In 1935, Mr. Peter Adams and I we divided properties as Mr. Sinner testified and he took possession of the Patterson properties and I took possession of the Newark properties.

(Page 45) Still Mr. Peter Adams, he was a guarantor to the Prudential Insurance Company and to the Fidelity Union Trust Company as a guarantor of his loans. Still, he was out of this corporation, the Newark Theatre Building Corporation and repeatedly he demanded that his signature must be eliminated from those bonds.

I repeatedly took the matter up with the Prudential Insurance Company and they refused to let Mr. Peter Adams' signature off the bond. Therefore, there was a search, I looked out to replace the Prudential mortgage and one company later gave me a loan without a personal guarantee. Now, in 1941, I figured that if I had some bonds perhaps I would have to put them as a collateral to get a loan in behalf of the Newark Theatre Building Corporation. That was the main object which we arrived at in this exchange from stocks to bonds.

Adam A. Adams, Petitioner—Direct.

Q. Now, this mortgage that was held by the Prudential Insurance Company, was that an open mortgage or did it still have a term to run? A. The Prudential Insurance Company had a mortgage from 1924 for five years and it ran to 1938 and the Prudential demanded money by paying them a fee, searching fee and some expenses, extended the mortgage for another three years, I presume up (Page 46) until 1941 or 1942.

Q. So that you knew that the mortgage would shortly become due and payable? A. Exactly.

Q. Now, what were the other reasons for the exchange? A. The other reasons was another mortgage held by the Fidelity Union Trust Company, the branch in Newark. In that, my brother was on the bond and he insisted that his signature must come out of that bond also.

Q. In other words, by his signature coming out of the bond, that he be relieved of liability by refinancing? A. Yes, sir.

Q. Now, was any purpose to save New Jersey franchise taxes?

Mr. Smith: Now, that is a pretty leading question.

Mr. Gutkin: I will withdraw that.

Q. Were there any other reasons? A. Well, as Mr Sinner stated I have two boys which they joined with me in business in 1941 and I want to give the boys some bonds.

Q. Did you believe that your operation of the business was of benefit to the corporation or did you think that a change of control would enure to the detriment of the corporation? (Page 47) A. I did that for the benefit of the corporation because even a second mortgage which I placed, the Newark Theatre derived the benefit because the present rate I am paying today is less than the Newark Theatre building was paying to the Prudential. The rate was 5%

to the Prudential and today I pay 4%. The present mortgage which I replaced the Prudential with is 4% instead of 5% which I paid to the Prudential. There is a benefit of 1% in interest on the mortgage.

Q. You have been engaged in the business of operating theatres in the State of New Jersey for how long a period of time? A. Since October 8, 1908.

Q. In what cities have you operated? A. First at 136 Market Street, Patterson, N. J.

Q. You needn't give the addresses, just the cities. A. Patterson, N. J.

Q. What other cities? A. Palisades Park, Palisade, N. J.; Newark, N. J. and Leonia, N. J.

Q. What has been the history of the movie theatre business in the City of Newark, N. J., in the downtown theatres where the 193-195 Market Street is located?

Mr. Smith: Since when?

Q. For the period of about 15 years prior to Jan. 27,
(Page 48) 1941, up to the end of 1941? A. I can't understand the question.

Q. What is the history, the trend of the theatre business in the downtown section of Newark for the years, 1926 to 1941, inclusive? A. Up to 1928 the theatres in downtown Newark, outside of two theatres that were controlled by independents—in 1928, the Warner Brothers acquired about 35 theatres in the vicinity of Newark and surrounding area and that became circuit control.

Q. Would you please try to talk a little louder, Mr. Adams? A. Now, in 1931, the Paramount Pictures, Inc., they were looking for an outlet for their pictures in the City of Newark and the City of Patterson. There were two or three theatres available to Paramount Pictures, Inc. They entered into an agreement with me as president of the Newark Theatre Building Corporation to make a 20 year deal

which we did under the specified conditions of the agreement.

Q. Was the theatre business prosperous or declining? A. The theatre business in 1931 was declining because the motion picture industry changed the production around 1929 from silent pictures to talking pictures, so like I said before there were two or three theatres available for Paramount, which they could rent in Newark. They entered into an (Page 49) agreement with me, because Paramount even today has an interest on 1,400 theatres and they are looking more for manpower than theatres.

Q. Now, Mr. Adams, coming back for a moment to the purposes of the recapitalization, you stated that one of the purposes was to have bonds available instead of stock so that it could be used by the corporation as collateral against any proposed loan the corporation might make to refinance. Now, in addition to that were there any other purposes?

Mr. Smith: Right there I object to counsel reciting what he said was the reason. I didn't hear it all myself and I don't know whether that is what he said.

Mr. Gutkin: The record will show what he said.

Q. What other purpose might there have been if you can recall any? A. As I said before, my boys——

Q. You said that, but in addition to that you were about to say something else? A. I can't recall.

Q. You started to say four hundred some odd dollars. What were you referring to? A. The State tax.

Mr. Gutkin: All right, your witness.

Cross examination by Mr. Smith:

(Page 50) Q. Mr. Adams, you have heard the accountant, Mr. Sinner, testify with reference to the books of your

partnership and of the Newark Theatre Building Corporation? A. That's right.

Q. And you also heard him testify as to the amount of the cost of your stock, did you not? A. Yes, I heard him mention it.

Q. Do you remember that? A. Yes.

Q. And you remember that we also had a discussion with reference to the amount of depreciation coming over from your partnership over to the corporation, do you remember that? A. Yes.

Mr. Smith: I would like to offer this protest as Respondent's Exhibit A for Identification.

The Court: Let it be marked.

(Protest received and marked Respondent's Exhibit A for Identification.)

Q. Mr. Adams, I show you a document which is marked "Protest" dated December 6, 1930, and ask you if that is your signature? A. Yes, that is my signature.

Q. And it is a protest to appeal as to certain depreciation factors? (Page 51) A. Yes.

Q. And that was prepared for you and signed by you, was it not? A. It was not prepared by me.

Q. I mean by your accountant? A. That's right.

Q. And signed by you? A. Yes, but I don't know who it was prepared by.

Q. And those are the statements that you signed and swore to in that document, that is your signature? A. Yes, sir.

Mr. Smith: I should like to offer this in evidence for the purpose of showing in this protest the taxpayer shows what reserve for depreciation was taken over from the corporation, reserve for depreciation that was in reserve by the partnership on December

31, 1927, on the buildings which are the subject of controversy in this case and which entered into the question of cost basis, which is an issue herein.

Mr. Gutkin: I object to the offer, your Honor, on the ground that it is not the best evidence of the facts that Mr. Smith is offering and that it is incompetent.

The Court: Objection overruled, admit it in evidence.

Mr. Gutkin: I take an exception.

(Page 52) The Court: Exception granted.

(Protest marked Respondent's Exhibit A for Identification received in evidence and marked Respondent's Exhibit A in evidence.)

Mr. Smith: No further questions.

Whereupon,

CHARLES F. KRAMER,

called as a witness on behalf of the petitioner, after having been duly sworn, testified as follows:

Direct examination by Mr. Gutkin:

Q. What is your full name? A. Charles F. Kramer.

Q. What is your address? A. 786 Broad Street, Newark, N. J.

Q. Mr. Kramer, would you kindly state your business or occupation? A. Real estate business and appraiser since 1900.

Q. How long have you been engaged in the appraisal of real properties? A. 40 years.

Q. And where is your appraisal business conducted? A. 786 Broad Street, corner of Market, Newark, N. J.

Charles F. Kramer, for Petitioner—Direct.

Q. In what vicinity generally do your appraisals take place, properties in what localities? A. Jersey, New Jersey, and particularly the Central (Page 53) part of New Jersey.

Q. Does that include the City of Newark? A. Oh, yes.

Q. Of what societies are you a member? A. All real estate organizations, a member of the New Jersey charter of the State Associations and National Association, the Master Appraisal Association, the American Appraisal Association, New York Industrial Brokers' Association, in fact all of them.

Q. Are you a member of the American Institute of Appraisers? A. Yes, sir, I am an M. A. I.

Q. Did you have any part in the founding of any of these appraisal societies? A. I am known as the dean of real estate men in this state.

Q. In other words, Mr. Kramer, I don't want you to feel as though you are saying some things that I have to draw from you, kindly help me to expedite your qualifications. Would you state some of the clients for whom you have made appraisals? A. Oh, yes, I can give you a few. In the last ten years I have served the United States Government, both Navy and Army; Interstate Commerce Commission; Chancery Court of the State of New Jersey; State Highway Commission of New (Page 54) Jersey; City of Newark, N. J.; City of Elizabeth, N. J.; City of Asbury Park, N. J.; City of Atlantic City, N. J.; Prudential Insurance Company of America; Fidelity Union Trust Company of Newark; Metropolitan Life Insurance Company; Guardian Life Insurance Company; Travellers' Life Insurance Company of Hartford, Conn.; Irving Trust Company; Penn. R. R.; Firemen's Insurance Company; United States Housing Authority; the Home Loan Bank.

Q. Have you ever served as an expert in condemnation proceedings? A. Oh, yes.

Q. And in what connection? A. I was employed by the City of Newark in the Newark Subway, acquisition of lands and rights of way; Pennsylvania R. R., Market St. Station and surrounding lands; the acquisition by condemnation of three United States Government housing units; acquisition of rights of way for Pennsylvania Railroad; Sears Roebuck Condemnation of Plants at Port Newark; Federal Shipbuilding Corporation's lands at Port Newark; Coastal Oil Company lands at Newark Bay. I was attached to the City of Newark Government for thirty years as real estate expert and tax consultant up until 1932 or 1933.

Q. Mr. Kramer, you recall that you were requested to investigate the properties owned by the Newark Theatre (Page 55) Building Corporation at 193-195 Market Street, in the City of Newark? A. Yes.

Q. Were you consulted in that connection? A. I was asked by Mr. Adams on September 20th, to make an appraisal of the Newark Theatre property and additional property at 286 Market Street.

Q. September of what year? A. This year, September 20th.

Q. 1944? A. 1944.

Q. Were you ever engaged in connection with an appraisal of the Market Street property at any time prior to September, 1944? A. Oh, yes, I appraised this property. I appraised it possibly half a dozen times for tax appeal purposes.

Q. Did you ever appraise it for any other purpose? A. No, I don't think so.

Q. Do you recall any appraisal that you made in 1940 with respect to this property? A. I may have, I have been making so many appraisals for various clients.

Q. In 1940, do you recall? A. I might have made one, I can't qualify as to whether I did or not. You are referring to this appraisal?

(Page 56) Q. I am referring to this appraisal. A. Oh, yes, I made this appraisal as of January 1, 1941 and got my notes out of examination of the property as of December 15th to December 30th of 1940.

Q. In other words, on December 15th to December 30th of 1940, you investigated this property and made an examination and made notes with respect to the property? A. Yes.

Q. And your valuation? A. Yes.

Q. Were you informed as to the reason for the request for appraisal? A. No, sir.

Q. Do you have any papers or documents that you can use to refresh your recollection with respect to the appraisal of the examination of the 193-195 Market Street, Newark? A. My appraisal as I made it and submitted it under my signature to Mr. Adams.

Q. Will you state what valuation you have arrived at for the property located at 193-195 Market Street and the basis for that valuation, stating all the factors that you used in arriving at the valuation?

Mr. Smith: Now, if Your Honor, please, he is putting the cart before the horse. He wants the valuation before he knows what he did to arrive at it and I object to the question.

(Page 57) The Court: Overruled, as of what date?

Mr. Gutkin: As of January 27, 1941.

The Witness: Yes, it will cover that period.

Q. Will you state the factors that led to your valuation, the method that you used to arrive at your valuation and finally the valuation? A. I appraised this property from

a reproduction and replacement standpoint, from an official survey and my personal inspection and knowledge of the property. The value of the land, consisting of a lobby, the portion fronting on Market Street, 39.67 by 100 feet, which I appraised at $3,000 a front foot, which makes $119,000. This property spread out in an "Ell" to a street known as Beaver Street, where its front 78.76 x 100 feet at $600 a front foot, a total of $47,256. The rear lands of Market and Beaver Streets comprise an area of 10,425 square feet, which I appraise at $5.20 a square foot or $54,306. There is an alleyway running in from Market Street on the westerly side of this property. We allow 5% for the alleyway or $3,128., giving a total land valuation of $223,700. I capitalized the building, which was built in 1890 and remodelled in 1927 or 1928 as follows: The theatre building is 60 feet high with eaves above the ground, 60 feet, and 20 feet with peak above eaves. It contains 1,078,222 cubic feet at 36¢ a cubic foot which is $388,160. Its main body is 51 years old but as (Page 58) same was remodelled in 1927, we only apply a 50% depreciation, $194,080., leaving a net value for the main building of $194,080.

On the Beaver Street "Ell", there is a four story and a two story brick building, a brick mercantile building, 45.5 x 46 x 51 feet high; two story 17.5 x 46 x 20 feet high, over 70 years old, in very poor condition, containing 107,523 cubic feet. There is a storage vault which contains 43,835 cubic feet. The boiler storage has 360 cubic feet and tunnels underneath 25,140 cubic feet, making a total of 176,958 cubic feet, which I value at 20¢ a cubic foot or $35,384. less 70% depreciation, which is $24,769., giving me a net value for this Beaver Street building of $204,695, added to my Market Street frontage gives me a total replacement and reconstruction value as of January 1, 1927, of $428,395.

Q. I think you misstated the date? A. January 1, 1927.

Q. I think you were referring to 1941? A. Yes, excuse me, January 27, 1941.

Q. What was the total value? A. $428,395.

Q. I show you a photograph which purports to be a photograph of the Theatre property in question and ask you whether this is a true photograph of the property? (Page 59) A. That is a true photograph I took myself from the frontage on Market Street, composed of about 40 odd feet and shows the lobby entrance to the main building.

Q. I show you another view of the same building? A. This is a lateral photograph taken showing the contiguousness of this building to Broad Street on the North side.

Q. I show you another photograph which purports to be the Beaver Street building? A. This is the four story and the two story building, the "Ell" running out from the main body to Beaver Street.

Mr. Gutkin: With consent of counsel for the respondent I offer in evidence the three photographs just identified by the witness.

The Court: Admitted in evidence.

(Photographs received in evidence and marked Petitioner's Exhibit No. 9 as of this date.)

Q. Now, Mr. Kramer, will you state what your investigation with respect to the ownership of this property revealed and the history of the operation of this building? A. My examination shows that there was a lease entered into——

Q. Pardon me, before that might I state that Page 5 of your report might be used to refresh your recollection in that connection. (Page 60) A. In my introductory I refer to the entire building being owned by the Newark Theatre Building Corporation and leased its entirety to the Essex Amusement Corporation by a long term lease.

Charles F. Kramer, for Petitioner—Direct.

This property has been assembled for over fifty years for the use of a theatre and the building was constructed in 1870 for a legitimate playhouse, containing an orchestra floor, balcony and gallery in addition to its large and well equipped stage, scenery and storage rooms and dressing rooms.

The house changed ownership several times in the early part of the century and finally was acquired by the present owners in 1921 who in the next years, thoroughly remodelled the building and removed the upper gallery.

This theatre was operated as a vaudeville house for a number of years and subsequently turned into an exclusive motion picture house. This latter event took place on or about March 13, 1931 when the owners leased the premises to the Essex Amusement Corporation for a period of 21 years, which lease expires on March 12, 1952, having twelve years to run from January 1, 1941.

Q. Now, will you describe the lease with respect to that property? A. Well, I have the lease here before me. It is a very lengthy one, but briefly it is a lease for a period (Page 61) of years that I have mentioned at $104,000 gross per year.

Q. Is the landlord required to pay the expenses of maintaining the building, taxes and other operating expenses, including salaries and so on? A. Yes.

Q. So that it is a gross rent, not a net rent? A. Yes.

Q. Have you investigated who the Essex Amusement Corporation might be? A. Well, I do know that Mr. Adams is part owner in it and I think if I understand rightly Paramount Theatre people may have an interest in it.

Q. I didn't mean exactly that, the Essex Amusement Corporation is a corporation of New Jersey, do you know? A. Yes.

Q. Now, will you state what has been happening with the locality of Broad and Market Street and Broad and

Mulberry Streets, in the City of Newark, in other words, what has been the trend? A. Market Street, from Broad Street east to Mulberry Street, consists of 100 per cent mercantile occupancy and for many years was the second best business and shopping center in Newark. The south side was considered the better trafficked side of this street.

Q. On which side is this? A. The theatre is located on the north side. The splendid service of the Public Service Corporation's trolley (Page 62) lines, which routed, the Irvington, Bloomfield, New York City, Orange and South Orange trolleys over this street to the Market Street Depot, were essentially responsible for much of the traffic and business done here. However, in 1926 many of these lines were rerouted and several important lines taken off the street, and with the removal of the Market Street Station of the Pennsylvania Railroad from the south of Market Street to the north side of said street, another decided change took place, for the traffic from Broad Street that formerly went to the Pennsylvania Railroad Station while on the south side of the street, now shifted to Commerce Street and Raymond Boulevard, causing a decided loss of traffic and its consequent effect upon the purchasing power and rentals and values. Many of the older firms removed from this section of Market Street and a great number of these buildings remained idle for many years, some as long as ten to fifteen years. Among these buildings are 223 Market Street, Ruckelshaus Building; 228 Market Street, Froehlich & Koehler Building; 224-226 Market Street, Spingarn Building; 185 Market Street, Niagara Building and 135 Market Street. In the years from 1925 to 1930, front foot values ranged from Five Thousand Dollars ($5,000) at Broad and Market Streets and gradually decreased toward Beaver Street and continued to do so to Mulberry Street, the range being from Four Thousand Dollars ($4,000) to Three Thousand Dollars

(Page 63) ($3,000) at Beaver Street and from Three Thousand Dollars ($3,000) to Two Thousand Dollars ($2,000) at Mulberry Street. In 1925 the stores and buildings were generally all occupied but already a beginning of lethargy became noticeable when the traffic fell off and the trolleys were rerouted. Merchants clamored for relief on their leases and readjustments of rental downward was a general occurrence.

In the next year, vacancies began to appear and the office buildings such as the Bonnell Building at 196 Market Street and the Niagara Building at 185 Market Street, had only the store floors rented at reduced rentals and lost their entire office tenants from the upper floors.

Front foot rental basis in 1920 to 1925, ran as high as Two Hundred Dollars ($200) to Three Hundred Dollars ($300) a front foot, only to drop to One Hundred Dollars ($100) to One Hundred and Fifty Dollars ($150) a front foot in 1930 and since this year to 1941, there no longer is any steadfast rental value but rather tenants were placed in various stores at rates ranging from Seventy-five Dollars ($75) to One Hundred Dollars ($100) a front foot with about 40% vacancies.

The trend was definitely and decidedly downward with little hope for any great betterment. The shrinkage was so rapid that the City Taxing Authorities could not keep pace with same and we find many of these properties offered for (Page 64) one-half of what they are assessed for taxation purposes.

The high prevailing tax rates, ranging from 5.30 to 5.50 was also a serious factor in this value shrinkage for none of these buildings could be rented at figures high enough to pay the overhead if taxation was not more moderate and commensurate with conditions.

Amid this chaotic condition there are only three properties that maintained their equilibrium during this depres-

sion period. They are the Newark Evening News at 215 Market Street, the Newark Theatre property at 193-195 Market Street and the Ordway Building at 207 Market Street, this latter being an office building.

Over 30% of the entire frontage on this block of Market Street, between Broad and Mulberry Streets, have been foreclosed against and are now in the hands of Banks and Insurance Companies.

These facts are stated to show the existing conditions during the years from 1925 to 1940 and for a better understanding for the arrived at values.

(Page 65) Q. Now, did you make an investigation as to the condition of motion picture houses in New Jersey in 1941, referring to Page 30 of your statement? A. Yes, sir, motion picture houses in the City of Newark I am sorry to say are in a very deplorable condition due to the fact that the success of a motion picture house depends upon the ability of procuring a first run picture and management that can maintain them and keep it up. Now, as a matter of fact it might be interesting, in 1940 I made an investigation of that question of motior picture houses in New Jersey so that in 1940 and 1941, of the 435 theatres in this state, 48 were closed. There are five first run picture houses in Newark. Each of these theatres has the policy of showing two pictures each week, which means that each theatre needs 104 first run pictures per year. In the period 1939, 1940 and 1941, the average first run pictures produced in America was under 400 a year. This means that the five theatres in Newark need a total of 520 pictures per year. Whereas, less than 400 were produced. Evidently the success of first run motion picture houses depend on the ability of the management to secure the pictures and net earnings are therefore closely tied up with the management and ability to secure the necessary productions. This is reflected in this appraisal property rentals, the feature of an extraordinary hazard

and the tenant finds him- (Page 66) self engaged in a highly speculative business.

Q. Now, Mr. Kramer, you made an appraisal based on the capital stock of the income and the expenses of the company and what is the amount of your appraisal based on that method? A. I made a capitalization appraisal on the basis of $104,000 gross rental and allowed for my yearly expenses as follows: Insurance $888.29; clerk, $227.75; average repairs, roofs and foundations as are specified in the lease, $1,000; water, $91.44; accountant and legal expenses $2,459.44; Miscellaneous, $768.96 all of which items were taken from the actuary books, making a total of $5,436., leaving me a net income of $98,564. As is customary, we apply to the land a value of 6% interest and $4.85 taxes for the year 1940 or 10.85 times the land value of $223,700 gives me $248,884., leaving me net value applicable to the building of $74,290., which I capitalized with a risk rate of 20% and taxes at $4.85 and depreciation rate of 5%, or a total of $29.85, capitalizing this amount $74,290. by $29.85, we have a value of $248,884., which added to my land value of $223,700. I have a total capitalized value of $472,584. and as I have stated before this is primarily based upon the fact that if we obtained the first run picture and the franchise for twenty years to maintain that first run picture and the able management that the building is under and has (Page 67) succeeded. If this building did not have the franchise and I had to appraise this property under personal conditions as I find it in the City of Newark, I would not appraise this property in the market value of over $250,000 and I state that advisably because last month or within the last 60 days two of our theatres outstanding, the Mosque, which cost three and a half million dollars, has a greater seating capacity than this house, located on Broad Street, was sold for around $200,000, and the Super Theatre which is also a house larger than this, costing close under $800,000 was sold for $225,000.

Q. I notice in your computation of expenses, you did not charge anything for management of the property? A. I left that out purposely because I thought possibly I would be unfair to the appraisal to charge up any management fee inasmuch as it was such an inter-related state of affairs.

Q. If any amount were to be charged for management— A. That would lessen my total value.

Q. Now, Mr. Kramer, do you know of any other leases on this north side of Market Street, properties located nearby? A. Mr. Counsel, I examined every lease and every piece of property from Broad Street down to Mulberry Street and as I told you 30% of them are pretty near all vacant, (Page 68) but the only outstanding lease that is in existence is the Grant Lunch Corporation, at 197-205 Market Street. That is on the same side and it has about 92 feet frontage by 100 feet deep and they paid $45,000 for it, and the only sale that has any semblance of bearing upon the situation is the sale of the Niagara building at 185 Market Street, which is three or four doors west of the property, at $66,000 and it has 22 feet and gives me a front foot value of about $3,000. Now, that is the only sale that exists.

Q. Now, did you make an appraisal of the property owned by the Newark Theatre Building Corporation at 286-288 Market Street? A. Yes, I did. I made an appraisal of the property at 286 and 288 Market Street, value of the land $29,022; building, $13,700; a total of $42,722. This property is located on the south side of Market Street, Newark, N. J., between Ward and Lawrence Streets, designated on the City Taxing Authorities maps as Block 161, Lots 10 and 11, and known as 286-288 Market Street, Newark, N. J.

Q. I show you a picture which purports to be a picture of the property at 286-288 Market Street, Newark, and ask whether that is the property? A. Yes, that is the property. I took that picture myself.

Charles F. Kramer, for Petitioner—Direct.

Mr. Gutkin: I offer it in evidence.
(Page 69) Mr. Smith: No objection.
The Court: Let it be marked.

(Picture received in evidence and marked Petitioner's Exhibit 10 in evidence.)

Q. Mr. Kramer, before we continue with that, may I ask you, am I correct in assuming that the property that you are talking about is the one which has a sign on it, "Friedman's Clothing", "Jay's Men's Shop", and "We Buy And Sell Diamonds"? A. That's right, three little stores, it is a taxpayer as it were.

Q. Now, will you kindly continue? A. This plot is rectangular in shape, having a frontage on Market Street of 51.08 feet, with a depth of 100 feet, running through and facing Kirks Place, with a frontage of 45.66 feet. Market Street runs east and west, is 75 feet wide and is paved with asphalt cement pavement, and contains all the municipal improvements such as sewer, water, gas and electricity. It is the principal business artery running from the easterly section of the city to the courthouse, at the junction of Market Street and Springfield Avenue. This street is utilized by the buses and trolley cars of the Public Service Corporation, with lines to Irvington, Oranges, West Newark and the New York-Newark Lines. The most recent sales, in 1940, indicates a land (Page 70) value of $600 a front foot for 100 feet depth. There being an assessive 48.37 feet frontage at $600 a front foot gives a land valuation of $29,022.

Q. A land valuation? A. Yes, sir.

Q. Now, what is the valuation of the building? A. The building is a one story brick taxpayer, covering the entire plot and divided into three stores. This building contains 82,800 cubic feet at 30¢ a cubic foot which is $24,840. Depreciation over 25 years, is $12,420., giving me a net value

for building of $12,420., added to my land value gives me a total value of $41,442.

Q. Now, will you state your appraisal on the basis of the capitalization method of the rental? A. On this building?

Q. Yes.

Mr. Smith: What building are you talking about now, which one?

Mr. Gutkin: 286-288 Market Street, Newark.

A. The yearly rental income as estimated is $4,000 and there existed between 1935 and 1940, 50% vacancies.

Q. Was that the condition and has it been the condition for vacancies? A. From 1935 to 1940 there was 50% vacancies there.

Q. I didn't hear you, I'm sorry? (Page 71) A. The yearly expense is insurance $246, applicable to land 6% on $29,000. is $1,740, or a total of $1,986., leaving applicable to the building $2,034., which capitalized was 6% risk rate, $4.85 tax rate and 4% depreciation, or a total of $14.85, giving me a value of $13,700. upon building and $29,000. for the land or $42,700.

Mr. Gutkin: No further questions.

Cross-examination by Mr. Smith:

Q. Your name is Mr. Kramer? A. Yes.

Q. And I believe you stated you have been an appraiser for a good many years for the City of Newark? A. Yes, 30 years.

Q. Are you now an appraiser for the City of Newark? A: Yes, sir, that is not officially connected with the city. I am doing their work for them.

Q. They are hiring you to make most of their appraisals? A. That is all expert cases. I have five cases for the City of Newark today.

Charles F. Kramer, for Petitioner—Cross

Q. Now, in making appraisals for the City, for the purposes of taxes I suppose, isn't it, or assessing taxes? A. A good deal of my work is for other purposes. I am the father of Port Newark and developed Port Newark and I have a lot of waterfront experience and I have to do a lot (Page 72) of condemnation but I did a lot of consulting with the Tax Board.

Q. Now, in making valuations of that type, do you not make them very low in comparison to their actual value? A. For the City?

Q. Yes. A. No, the law calls for making true valuations in Jersey and we are supposed to do so.

Q. You are supposed to, but you do not? A. I say generally that some of the valuations are much lower than the true value.

Q. The petitioner had made a protest in 1940 over the valuation that was placed on this particular property we have in controversy. He protested to the Appeals Board?

Mr. Gutkin: I object to the question on the ground that this witness may not know what the petitioner has done and if he knows it, all right.

The Court: If he knows. Do you know whether or not he had appealed?

The Witness: I don't know whether he had made one in 1940 or not.

The Court: You don't know?

The Witness: No.

The Court: And when you made this appraisal you read there from a long document.

(Page 73) The Witness: That is my appraisal.

By Mr. Smith:

Q. Did you not make that in connection with the City appraisal also, isn't that a part of that? A. Oh, no.

Charles F. Kramer, for Petitioner—Cross.

Q. It doesn't have anything to do with that? A. No.

Q. Now, when Mr. Adams approached you about this matter what did he say to you? A. He said very little. The day he called me up he said, "I want an appraisal made of the property, the true value of my property at the theatre and down below and I want it ready and in the hands of Mr. Gutkin within the next five days."

Q. And he didn't tell you the purpose? A. No, sir, he never mentioned a word about it. I didn't even know it was a court case until a couple of days ago Mr. Gutkin told me.

Q. You didn't know it would have anything to do with the income tax case? A. Positively not, sir.

Q. Now, the main property here is 193-195 Market Street? A. Yes, sir.

Q. In the City of Newark? (Page 74) A. Yes, sir.

Q. Market Street is considered one of the main streets, isn't it, of Newark? A. One of the most important arteries running through the entire city, east and west.

Q. And on that are many business properties? A. Generally business.

Q. And several theatres? A. Yes, two theatres.

Q. And this property is one of the largest, is it not, of the theatres? A. Yes, sir, it is one of the largest centrally located theatre properties.

Q. And what is the seating capacity? A. 1,900.

Q. And it has been recently re-decorated, hasn't it? A. I don't keep track of that, but they are always doing a little something in theatres.

Q. Well, you made a very careful investigation of this property, didn't you? A. Yes.

Q. What is in the lobby, did you examine the lobby? A. It is decorated nicely, yes, sir, they change them every once in a while. They change the entire decorations.

(Page 75) Q. And those decorations are new there, aren't they? A. I should say they are very, very neat and very nice.

Mr. Gutkin: As of what date are we talking about?

Mr. Smith: Of the investigation he made in 1941.

Q. And you did this by the foot frontage, is that the way you estimated, your value? A. The Market Street frontage, I applied that by foot frontage and the Beaver Street also foot frontage.

Q. Beaver Street is where, in the back of the theatre? A. On the side in front Walker Street, a lateral street and this is an ell that runs out from the theatre into Beaver Street.

Q. Now, in making this examination what factors did you take into consideration? A. In regard to what?

Q. In regard to value of this property, what factors did you use? A. Factors as to what?

Q. As to making valuation, what did you consider? A. The front foot valuation as I knew it upon my experience from adjoining sales and leases.

Q. That is the way you did it? A. Yes.

Q. You did not take into consideration the earnings here, did you? (Page 76) A. Earnings?

Q. Yes, sir. A. I gave you a capitalized value statement here, I read that off.

Q. Now, when you made that capitalization, you said that that capitalization was 20%, did you not? A. Yes, sir.

Q. Why did you say 20%? A. Because of the enormous and excessive hazard and risk that this theatre is under and the condition of the motion picture industry not being able to pay the rents unless they have a first-run picture franchise.

Q. Well, the petitioner, the stock which we have in mind is the Newark Theatre Building Corporation stock? A. Yes.

Q. And they are the owners of the building? A. Yes.

Q. Now, they have a lease with the Essex Amusement Corporation? A. Yes.

Q. And the Essex Amusement Corporation is a subsidiary of the Paramount Theatre? A. That I don't know, I only understand that they share an interest in the Essex Amusement Company.

Q. Aud they do get the first run Paramount pictures, (Page 77) do they not? A. They have an agreement with the Paramount people I understand.

Q. Well, there isn't any risk there; can't the Paramount Pictures see to it that the pictures get there? A. I quoted that in my testimony that the assignment of pictures at the present time is very scarce and getting worse by the minute and in 1940 there were only 400 pictures produced and over 512 necessary to serve the theatres. In fact, this very theatre has to run the same picture for three or four weeks in order to bridge that situation.

Q. And do they not have capacity crowds for every picture? A. Do they have what?

Q. Capacity crowds? A. That I can't say, but they have good attendance, but I don't think the capacity is a very large word in this.

Q. Well, isn't the theatre filled up about four times a day?

Mr. Gutkin: Are we talking about 1941?

Mr. Smith: I am talking about 193-195.

The Witness: In 1940 it was not filled up to capacity as you speak of.

Q. Now, the different properties, that you don't know much about that though, do you? (Page 78) A. About what?

Charles F. Kramer, for Petitioner—Cross.

Q. How many people are going to the theatres? A. In this theatre?

Q. Yes. A. My office is right next door and I guess I pass that theatre about twenty times a day and I am in the theatre and out of the theatre very frequently and I think I know as much about it as anybody who has anything to do with the theatre.

Q. So that the theatre being located in downtown Newark and having a first run picture, is customarily filled up; isn't it, hasn't that been your observation? A. Better than the other houses. The other houses do not have anybody.

Q. Now, there is a lease in connection with this theatre that you speak about? A. Yes.

Q. I show you a document which is marked "Newark Theatre, Newark, N. J. lease" and ask you if that is the document you are talking about? A. Is this 1931?

Q. Yes. A. That's right.

Q. And this lease is dated March 13, 1931? A. Yes.

(Page 79) Q. And is to run for how long? A. 21 years.

Q. So that you still have from 1941, you still have ten years? A. Yes.

Q. And this lease calls for rent of $104,000 a year? A. Yes.

Q. Now, did you say that the expenses with reference to the running, that is the interest and so forth are to be taken care of by the landlord, the repairs? A. Yes.

Q. Well, how about new seats and all that inside stuff? A. That is covered by the agreement and the lease, the company pays that.

Q. You mean the lessee? A. Yes.

Mr. Smith: I would like to offer the lease in evidence in order that we will have it before us.

Charles F. Kramer, for Petitioner—Re-direct.

Mr. Gutkin: Will you please offer a copy, Mr. Smith?

The Court: You offer in evidence a copy of the lease, subject to comparison, Mr. Smith?

Mr. Smith: That's right, with the original.

Mr. Gutkin: No objection.

The Court: Let it be admitted.

(Page 80) (Copy of lease received in evidence and marked Respondent's Exhibit B in evidence.)

Q. If this lease has ten years to run, how can you justify a capitalization at 20%? A. Conditions, not the lease. The conditions surrouunding the moving picture industry and the hazard that it is laboring under has everything to do with the success of this lease and the success of this house.

Q. Even though the Paramount Theatre people themselves have their own pictures in there, is that right? A. Yes, that's got nothing to do with it. The Paramount Pictures may cease tomorrow morning if they are going the way they are now making fewer pictures everyday. It is hard to guess where they are going to wind up.

Mr. Smith: No further questions.

Re-direct examination by Mr. Gutkin:

Q. Mr. Kramer, are you familiar with the status of the corporation that was the tenant's lessee in 1935? A. Yes.

Q. What was that, the lessee?

The Court: The Essex Amusement Company.

Mr. Gutkin: I withdraw that, your Honor, no further questions.

The Court: That is all, Mr. Kramer.

Adam A. Adams, Petitioner, Recalled—Direct.

(Page 81)

ADAM A. ADAMS,

recalled as a witness on behalf of the petitioner, having already been duly sworn, resumed the stand and testified further as follows:

Direct examination by Mr. Gutkin (continued):

Q. Mr. Adams, you have heard the testimony with respect to this lease between the Newark Theatre Building Corporation and the Essex Amusement Company? A. Yes.

Q. What was the status of the lessee for years leading up to the year 1940 and 1941? A. When we entered the lease with the Paramount, Paramount wanted 50% of the Essex Amusement Company and at that time my brother wants 25% and I want 25%, that makes 100%. Now, in 1932, the Paramount, Incorporatives with all their affiliates went into bankruptcy and their receiver ran the Paramount Pictures and Paramount Pictures for a number of years to about 1935 or 1937 was run like that. During that time the Essex Amusement Corporation was unable to pay the rent to the Newark Theatre Building Corporation and if it was not for my own personal funds to put in, the Essex Amusement Corporation, for their rent, the Essex Amusement Corporation would have gone into bankruptcy like the rest of the Paramount Theatres. (Page 82) If it was not for me, my personal funds which kept the Essex Amusement Corporation out of bankruptcy, it would have gone into bankruptcy. That particular lease we entered in 1931 and the Commissioner will find from the lease, if the Paramount did secure my personal services, I had a contract of an additional five years with the Paramount people that I will manage the theatres and on that condition they entered the lease with the Newark Theatre Building Corporation for the Essex Amusement Company.

Adam A. Adams, Petitioner, Recalled—Cross.

The Court: You featured other movies more than those produced by Paramount?

The Witness: Maybe 2%.

The Court: How many first run movies does Paramount put out a year?

The Witness: Up to 1928 before the talking pictures they used to produce between 600 and 700 pictures a year since prior to 1928. After the talking pictures, the cost of each picture was three times as great than it would cost to produce a silent picture, therefore, all the producers curtailed production. Instead of having 700 pictures they got down to 300 or 350 pictures. They continued like that up to 1941 or 1942. Now, since our country entered the war because of the restrictions for celluloid which is required to produce the pictures, the pictures have been curtailed 50%. In other words, (Page 83) my records show today that back in 1935, 1936, 1937, 1938, I showed usually two pictures a week. Today, I run for instance one picture "Going My Way" for seven weeks, not because that picture should run seven weeks, but I had no other picture to follow it. In other words, I say Paramount today out of sixty pictures which they today have produced, no more than fifteen decent pictures are among them.

Q. Have you any security for your lease? A. No, sir.

Mr. Gutkin: You may cross examine.

Cross examination by Mr. Smith (continued):

Q. Mr. Adams, the Essex Amusement Company in 1941 was doing very well then, wasn't it? A. 1939, 1940, Essex acquired another theatre in Newark.

Adam A. Adams, Petitioner, Recalled—Cross.

And the other theatre did not go so good, that is the old Super Theatre which Mr. Kramer mentioned. That particular theatre was a failure for fifteen years. It was operated by different operators who tried to run the theatre successfully and they failed. In 1939, I acquired the building myself from the Prudential Insurance Company. The Essex Amusement Corporation took a lease on that building. We operated it in 1940 and 1941. (Page 84) Now, that particular theatre which I stated before was a failure for fifteen years, under my management is one of the outstanding theatres of the City of Newark.

Q. Now, Mr. Adams, I will show you what is called a gift tax return, a United States gift tax return for the year 1941 and ask you if that is your signature there on it? A. Yes.

Q. And you gave some of these deductions* which you acquired to your children that year in which you reported here? A. That's right.

Q. And you gave a value as stated in the return of $24,000——

Mr. Gutkin: Objected to, your Honor. I don't know whether Mr. Smith is making the witness his own for the purposes of this examination.

Mr. Smith: I don't know what he put the witness back on for. He seemed to put him back on too, which is irregular. What I want to do is to put in the gift tax return of the petitioner to show what value he put on these debentures when he gave them away in 1941, the exact date of the transaction here.

Mr. Gutkin: I think that might only be used to impeach the testimony of the witness.

(Page 85) The Court: Objection overruled.

Mr. Gutkin: I pray an exception.

* Corrected: debentures

Adam A. Adams, Petitioner, Recalled—Cross.

The Court: Exception noted.

(Gift Tax return received in evidence and marked Exhibit C in evidence.)

Q. Mr. Adams, this appraisal that was made in 1941 by Mr. Kramer at your request, did you or did you not tell him the purpose of which you were making the appraisal? A. I did not, I was trying to negotiate a loan for different insurance companies. I did not tell Mr. Kramer what I want the appraisal for and the reason which I asked Mr. Kramer to appraise my property was because I was looking for a loan and I wanted to satisfy myself how much my property was worth. That is the reason I asked Mr. Kramer to make an appraisal.

Q. Did you not make an appeal on this property from the assessment in 1940, did you or did you not? A. I don't know.

Mr. Smith: No further questions.

Mr. Gutkin: The petitioner rests.

Mr. Smith: It has been agreed that we put in these returns. I offer in evidence, I believe it will be better as separate exhibits, the corporation income tax returns of the Newark Theatre Building Corporation for the years 1928 to 1943 inclusive. We claim the debentures (Page 86) are worth their face value, which is $295,000 alone, not counting what the value of the stock might be in addition.

The Court: Any objection?

Mr. Gutkin: No objection to the introduction in evidence, but in characterizing its use for any purpose. I merely have no objection to the admission in evidence of these returns.

The Court: Admitted in evidence.

Colloquy.

(Returns received in evidence and marked Respondent's Exhibits E to [illegible] inclusive in evidence, for the years 1929 to 1943.)

The Court: Under the rules you know, gentlemen, the briefs in chief are to be filed simultaneously within 45 days and the reply briefs within 15 days. I don't see any reason why they should not be filed as provided for.

Mr. Gutkin: May I ask Your Honor's indulgence in asking the petitioner to submit within 60 days? I have so much work pending before the Tax Court in other cases and appeal matters, that it will be extremely difficult to write an adequate brief in 45 days.

The Court: Is there any objection?

Mr. Smith: No objection.

The Court: All right, 60 days and 15 days.

(Whereupon, at 5:15 P. M., the hearing terminated.)

Exhibit P-2.

MINUTES OF MEETING OF BOARD OF DIRECTORS.

A special meeting of the Board of Directors of Newark Theatre Building Corporation was held on Friday, December 6, 1940, at 3 P. M., at the principal office of the company in Newark, N. J., pursuant to a written waiver of notice signed by all of the Directors fixing said time and place.

The entire Board of Directors was present.

The Secretary presented and read the waiver of notice of meeting signed by all of the Directors, and the same was ordered filed.

The President stated that the meeting had been called to consider the desirability of revamping the capital structure of the company. He pointed out that in his opinion the whole capital structure of the company was not well balanced and that it was not sound business to have so top-heavy a capital set-up. He stated that in his judgment a simple plan of recapitalization could be evolved which would bring about the desired change with comparatively little expense to the company and which would eventually prove beneficial not only to the company but to its stockholders. He further advised that he had discussed the same with the accountant for the company, as well as counsel, and that they could see no accounting or legal difficulty in consummating a plan of recapitalization.

He suggested that the following plan be considered:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

Exhibit P-2.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

After a full discussion, upon motion, duly made and seconded, and by the affirmative vote of all present, it was

RESOLVED that the Board of Directors of this company deem it desirable and for the best interests of the company and its stockholders, and hereby declare it to be advisable that the present capital structure of this company be changed to provide for the following:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

Exhibit P-2.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

And Whereas, in order to carry out the aforesaid plan of recapitalization, it is necessary and advisable to amend the certificate of incorporation of this company, it is

Resolved that the Board of Directors of Newark Theatre Building Corporation, a corporation of the State of New Jersey, on this 6th day of December, A. D., 1940, do hereby resolve and declare that it is advisable to amend Article Fourth of the certificate of incorporation of the company to read as follows:

> "Fourth: The total authorized capital stock of this corporation is 5,914 shares without nominal or par value. All or any part of said shares may be issued by the corporation from time to time and for such consideration as may be determined upon and fixed by the Board of Directors as provided by law."

Exhibit P-2.

and do hereby call a meeting of the stockholders to be held at the company's office in the City of Newark, County of Essex, N. J., on the 6th day of December, 1940, at 4 P. M., to take action upon the above resolution.

FURTHER RESOLVED that the officers of this corporation be and they hereby are authorized and directed to do all acts and things that may be necessary and proper to carry into effect the foregoing plan of recapitalization, in compliance with the laws of the State of New Jersey.

There being no further business to come before the meeting, the meeting adjourned.

MARTIN W. D ARCY,
Secretary.

WAIVER OF NOTICE OF MEETING OF STOCKHOLDERS.

We, the undersigned, being all of the stockholders of Newark Theatre Building Corporation, a corporation organized under the laws of the State of New Jersey, hereby waive notice of the time, place and purpose of a meeting of the stockholders of the corporation, and fix the 6th day of December, 1940, at 4 P. M., as the time, and the principal office of the company, 193-5 Market Street, Newark, N. J., as the place of said meeting.

And we hereby waive all the requirements of the statutes of New Jersey as to notice of said meeting and the publication thereof; and consent to the transaction of such business as may come before said meeting.

Dated: December 6, 1940.

A. A. Adams (L. S.)
Marie A. Adams (L. S.)
Martin W. D Arcy (L. S.)

Exhibit P-2.

MINUTES OF SPECIAL MEETING OF STOCKHOLDERS.

A special meeting of the stockholders of Newark Theatre Building Corporation was held on Friday, December 6, 1940, at 4 P. M., at the principal office of the company in Newark, N. J., pursuant to a written waiver of notice signed by all of the stockholders fixing said time and place.

All the stockholders were present.

The Secretary presented and read the waiver of notice of meeting signed by all of the stockholders, and the same was ordered filed.

The President stated that the meeting had been called to discuss and take action upon a plan of recapitalization of the company which had been considered and unanimously adopted by the Board of Directors. He directed the Secretary to read the resolutions passed by the Board of Directors and that they be entered in the minutes of this meeting. The Secretary read as follows:

"RESOLVED that the Board of Directors of this company deem it desirable and for the best interests of the company and its stockholders, and hereby declare it to be advisable that the present capital structure of this company be changed to provide for the following:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st

in each year, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

And Whereas, in order to carry out the aforesaid plan of recapitalization, it is necessary and advisable to amend the certificate of incorporation of this company, it is

Resolved that the Board of Directors of Newark Theatre Building Corporation, a corporation of the State of New Jersey, on this 6th day of December, A. D., 1940, do hereby resolve and declare that it is advisable to amend Article Fourth of the certificate of incorporation of the company to read as follows:

> 'Fourth: The total authorized capital stock of this corporation is 5,914 shares without nominal or par value. All or any part of said shares may be issued by the corporation from time to time and for such consideration as may be determined upon and fixed by the Board of Directors as provided by law.'

and do hereby call a meeting of the stockholders to be held at the company's office in the City of Newark, County of

Exhibit P-2.

ssex, N. J., on the 6th day of December, 1940, at 4 P. M., to take action upon the above resolution.

FURTHER RESOLVED that the officers of this corporation be and they hereby are authorized and directed to do all acts and things that may be necessary and proper to carry into effect the foregoing plan of recapitalization, in compliance with the laws of the State of New Jersey."

After a full discussion, upon motion, duly made and seconded, and by an affirmative vote of all present, it was

RESOLVED that the stockholders of this company do hereby ratify and approve the resolutions passed by the Board of Directors of this company providing for a revision of the capital structure of the corporation in the manner and terms set forth in said resolutions.

FURTHER RESOLVED that the proper officers of this company be and they hereby are authorized to execute and deliver any and all documents, papers, stock certificates, and bonds, that may be necessary to carry out said plan of recapitalization and as may be required by law.

There being no further business to come before the meeting, the meeting adjourned.

MARTIN W. D'ARCY,
Secretary.

Exhibit P-4.

Number 3

Shares 5903

Incorporated Under the Laws of the State of New Jersey

NEWARK THEATRE BUILDING CORPORATION

The corporation is authorized to issue 5,914 shares of stock without par value

FULL PAID AND NON-ASSESSABLE

THIS CERTIFIES THAT ADAM A. ADAMS is the owner of Five Thousand Nine Hundred Three Shares Without Par Value of

NEWARK THEATRE BUILDING CORPORATION

transferable on the books of the Corporation by the holder hereof in person or by duly authorized Attorney, upon surrender of this Certificate properly endorsed.

WITNESS the Seal of the Corporation and the (Seal) signatures of its duly authorized Officers affixed this twenty-seventh day of January 1941.

THOMAS A. ADAMS
Secretary
Treasurer

A. A. ADAMS
President

Exhibit P-5.

UNITED STATES OF AMERICA
STATE OF NEW JERSEY

No. 10 $12,000.00

NEWARK THEATRE BUILDING CORPORATION

6 Per Cent. Twenty Year Debenture
Due December 1st, 1960

NEWARK THEATRE BUILDING CORPORATION (hereinafter called the "Corporation"), for value received, hereby promises to pay to

ADAM A. ADAMS

or order, on the 1st day of December, 1960,

Twelve Thousand and no/100 Dollars

in legal currency of the United States of America, and to pay interest thereon from date of issuance, at the rate of Six (6) per cent. per annum, such interest to be payable in like legal currency, on the first days of June and of December in each year. Both the principal and interest of this debenture shall be payable at the office of the Corporation, 195 Market Street, Newark, N. J.

In the payment of their several claims in the event of liquidation or insolvency of the Corporation, the holder of this debenture shall rank pari passu with all other unsecured creditors of the Corporation, and superior to the stockholders of the Corporation with respect to their shares of stock.

This debenture is part of a duly authorized issue of $295,700.00 par value of 6% Twenty Year Debentures of the Corporation. All of said debentures are issued under and pursuant to resolutions of the Board of Directors

of the Corporation, enacted on December 6, 1940, and approved by the vote of at least two-thirds of the stockholders of the Corporation.

This debenture is transferable only on the books of the Corporation in person or by duly authorized attorney, upon surrender of this debenture properly endorsed.

In Witness Whereof, Newark Theatre Building Corporation has caused this instrument to be signed by its President, and its corporate seal, attested by its (Seal) Secretary, to be hereunto affixed, all as of this 27th day of January A. D., 1941.

Newark Theatre Building Corporation

By A. A. Adams
President

Attest:

Thomas A. Adams
Secretary

Exhibit P-6.

CERTIFICATE OF DECREASE OF CAPITAL STOCK AND AMENDMENT OF CERTIFICATE OF INCORPORATION OF NEWARK THEATRE BUILDING CORPORATION

The location of the principal office in this state is at 193-195 Market Street, in the City of Newark, County of Essex.

The name of the agent therein and in charge thereof, upon whom process against this corporation may be served, is Adam A. Adams.

RESOLUTIONS OF DIRECTORS

RESOLVED that the Board of Directors of this company deem it desirable and for the best interests of the company and its stockholders, and hereby declare it to be advisable that the present capital structure of this company be changed to provide for the following:

(1) A reduction in the aggregate par value of the authorized capital stock of this company from $600,000, represented by 6,000 shares of the par value of $100.00 each, of which 5,914 shares, or $591,400, are issued and outstanding, to $295,700, to be divided into 5,914 shares of stock without nominal or par value.

(2) The issuance by the company of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, and the principal whereof shall be payable in twenty years from the date thereof.

(3) The issuance by the company to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable

semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered.

And Whereas, in order to carry out the aforesaid plan of recapitalization, it is necessary and advisable to amend the certificate of incorporation of this company, it is

Resolved that the Board of Directors of Newark Theatre Building Corporation, a corporation of the State of New Jersey, on this 6th day of December, A. D., 1940, do hereby resolve and declare that it is advisable to amend Article Fourth of the certificate of incorporation of the company, to read as follows:

> "Fourth: The total authorized capital stock of this corporation is 5,914 shares without nominal or par value. All or any part of said shares may be issued by the corporation from time to time and for such consideration as may be determined upon and fixed by the Board of Directors as provided by law."

and do hereby call a meeting of the stockholders to be held at the company's office in the City of Newark, County of Essex, N. J., on the 6th day of December, 1940, at 4 P. M., to take action upon the above resolution.

Further Resolved that the officers of this corporation be and they hereby are authorized and directed to do all acts and things that may be necessary and proper to carry into effect the foregoing plan of recapitalization, in compliance with the laws of the State of New Jersey.

Exhibit P-6.

In Witness Whereof, the said corporation has caused this certificate to be signed by its President and Secretary and its corporate seal to be hereto affixed, this 6th day of December, 1940.

Newark Theatre Building Corporation

By A. A. Adams,
President.

Martin W. D'Arcy,
Secretary.

Certificate of Change

Newark Theatre Building Corporation, a corporation of the State of New Jersey, doth hereby certify that pursuant to and by virtue of title 14 of the Revised Statutes of the State of New Jersey it has voted to decrease the capital stock of the company from an authorized capital stock of $600,000, divided into 6,000 shares of the par value of $100.00 each, of which 5,914 shares are presently issued and outstanding, to $295,700, represented by 5,914 shares of capital stock without nominal or par value, the manner, terms and conditions of effecting said decrease being the issuance by the company, to the holders of the present capital stock, of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the

Exhibit P-6.

basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered, said decrease and the manner of effecting same and the terms and conditions thereof having been declared by resolution of the Board of Directors of said corporation (hereinbefore recited) to be advisable and having been duly and regularly assented to by the vote of at least two-thirds of the stockholders at a meeting duly called by the Board of Directors for that purpose; and the written assent of said stockholders is hereto appended.

In Witness Whereof, the said corporation has caused this certificate to be signed by its President and Secretary and its corporate seal to be hereto affixed, this 6th day of December, 1940.

Newark Theatre Building Corporation

By A. A. Adams
President

(Seal)

Martin W. D'Arcy
Secretary

State of New Jersey }
County of Essex } ss.:

Be It Remembered that on this 6th day of December, 1940, before me, the subscriber, a Notary Public of New Jersey, personally appeared Martin W. D'Arcy, Secretary of Newark Theatre Building Corporation, the corporation mentioned in and which executed the foregoing certificate, who, being by me duly sworn on his oath, says he is such Secretary, and that the seal affixed to said certificate is the corporate seal of said corporation, the same being well

Exhibit P-6.

known to him; that Adam A. Adams is President of said corporation and signed said certificate and affixed said seal thereto and delivered said certificate by authority of the Board of Directors and with the assent of at least two-thirds in interest of the stockholders of said corporation as and for his voluntary act and deed and the voluntary act and deed of said corporation in the presence of deponent, who thereupon subscribed his name thereto as witness.

And he further says that the assent hereto appended is signed by at least two-thirds in interest of the stockholders of said corporation, either in person or by their several duly constituted attorneys-in-fact thereunto duly authorized in writing.

MARTIN W. D'ARCY.

Subscribed and sworn to before me this 6th day of December, 1940.

HELEN CORDING
Notary Public of New Jersey

STOCKHOLDERS' ASSENT TO CHANGE.

We, the subscribers, being all of the stockholders of Newark Theatre Building Corporation, having at a meeting regularly called for the purpose, voted in favor of decreasing the capital stock from an authorized capital stock of $600,000, divided into 6,000 shares of the par value of $100.00 each, of which 5,914 shares are presently issued and outstanding, to $295,700, represented by 5,914 shares of capital stock without nominal or par value, the manner, terms and conditions of effecting said decrease being the issuance by the company, to the holders of the present capital stock,

Exhibit P-6.

of debenture bonds in the aggregate principal sum of $295,700, which debenture bonds shall bear interest at the rate of six per cent. per annum, payable semi-annually, on June 1st and December 1st in each year, and the principal whereof shall be payable in twenty years from the date thereof, plus 5,914 shares of the new common stock of the company without nominal or par value, in exchange for the shares of the present capital stock of the par value of $100.00 per share now held by them on the basis of one $50.00 bond and one share of stock without nominal or par value for each share of the present capital stock surrendered, hereby give our written assent to said change.

WITNESS our hands and seals this 6th day of December, 1940.

Name		Number of Shares
A. A. ADAMS	(L. S.)	5903 shares
MARIE A. ADAMS	(L. S.)	ten shares
MARTIN W. D ARCY	(L. S.)	one share

Endorsed:

"Filed and Recorded Dec 10 1940
Thomas A. Mat[illegible],
Secretary of State."

Exhibit P-6.

STATE OF NEW JERSEY

Department of State

I, Thomas A. Mathis, Secretary of State of the State of New Jersey, do hereby certify that the foregoing is a true copy of Certificate of Decrease of Capital Stock and Amendment of Certificate of Incorporation of Newark Theatre Building Corporation, and the endorsements thereon, as the same is taken from and compared with the original filed in my office on the Tenth day of December, A. D. 1940, and now remaining on file and of record therein.

In Testimony Whereof, I have hereunto set my hand and affixed my Official Seal at Trenton, this Tenth day of December, A. D. 1940.

(Seal)

Thomas A. Mathis,
Secretary of State.

Exhibit P-7.

NEWARK THEATRE BUILDING CORP.
NEWARK, NEW JERSEY

BALANCE SHEET
AS AT: DECEMBER 31st, 1940

ASSETS

Real Estate:			
Land, 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	245,926.20	227,008.80	
			$698,408.80
Land, 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	44,333.41		
		46,881.47	
Equipment: Heating plant	718.72		
Less depreciation	479.13	239.59	
			155,121.06
Equipment:			
Theatre furniture and fixtures		61,703.37	
Less depreciation		56,230.87	
			5,472.50
Other:			
Cash in banks		$ 42,107.02	
Deposit a/c Gus Pappas		100.00	
Accrued interest receivable		77.81	
Unexpired insurance		503.66	
Rents receivable		635.00	
Notes receivable: Premier Amusement		41,500.00	
			84,923.49
Total assets			$943,925.85

Exhibit P-7.

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 60,000.00	
Mortgage payable, Prudential	231,250.00	
		$291,250.00
Accounts payable		1,031.75
Accruals:		
Federal capital stock tax	452.10	
Interest on mortgages	2,890.63	
Federal income and declared value excess profits tax	9,772.32	
		13,115.05
Total liabilities		$305,396.80

CAPITAL

Common stock	$591,400.00
Surplus: Donated surplus	1,500.00
Surplus	45,629.05
Total liabilities and capital	$943,925.85

Exhibit P-8.

NEWARK THEATRE BUILDING CORP.
NEWARK, NEW JERSEY

EXHIBIT "A"

BALANCE SHEET
AS AT: DECEMBER 31st, 1941

ASSETS

Real estate:			
Land: 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	264,843.60	208,091.40	
			$679,491.40
Land: 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	48,061.53	43,153.35	
Equipment: Heating plant	718.72		
Less depreciation	527.05	191.67	
			151,345.02
			830,836.42
Other:			
Cash in bank		44,537.88	
Deposit, Gus Pappas Agent (a/c)		100.00	
Unexpired insurance		2,224.58	
Rents receivable		2,354.58	
Notes receivable – (Premier Amusement Corp.)		38,000.00	
			87,217.04
Total assets			$918,053.46

Exhibit P-8.

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 56,000.00	
Mortgage payable, 193-195 Market St.	206,250.00	
		$262,250.00
Debentures payable		295,700.00
Current:		
Accounts payable	532.25	
Accrued taxes	281.25	
Accrued interest	4,056.63	
Reserve for Federal income tax (1940)	274.38	
Reserve for Federal income tax (1941)	4,840.13	
		9,984.64
Total liabilities		$567,934.64

CAPITAL

Common stock issued (5,914 shares N. P. V.)	$295,700.00
Surplus:	
Donated surplus	1,500.00
Net operating surplus	52,918.82
Total liabilities and capital	$918,053.46

Opinion.

THE TAX COURT OF THE UNITED STATES

ADAM A. ADAMS, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 4109. Promulgated April 26, 1945.

Petitioner was the principal owner of the common stock of X corporation, which had no other class of stock and no bonds. Pursuant to a plan of recapitalization, petitioner exchanged his stock having a par value of $100 per share for new, no par value common stock having a stated value of $50 per share and 20-year debenture bonds of X bearing 6 per cent interest of a face amount equal to one-half of the par value of the old stock. No change was made in the surplus account of X and no declaration of a dividend was made. The purpose of the recapitalization was to minimize state franchise taxes and the Federal income tax liability of X. *Held*, recapitalization was for a legitimate business purpose and the debentures received by petitioner in the exchange did not constitute a taxable dividend.

Sydney A. Gutkin, Esq., for the petitioner.

Jonas M. Smith, Esq., for the respondent.

The Commissioner determined a deficiency in petitioner's income tax for the calendar year 1941 in the amount of $113,021.44.

Aside from one small item not in dispute, the deficiency results from respondent's finding that an exchange by petitioner of common stock of the Newark Theatre Building Corporation for new common stock and debenture bonds of

the same corporation in January 1941, in connection with a plan of recapitalization of that company, resulted in the distribution of a dividend to petitioner constituting fully taxable income.

The petitioner contends that the transaction was a recapitalization and reorganization within the meaning of section 112 of the Internal Revenue Code and was not a distribution of a dividend; and, in the alternative, he contends that there was a loss from the transaction rather than a gain; that if there was a gain, it was taxable as a capital gain; and that if it is to be treated as a dividend, it was a dividend of no value.

Since we are of the opinion that petitioner is correct in his primary contention, we consider it necessary to make findings of fact upon this issue only.

Findings of Fact.

Petitioner is an individual, residing in New Jersey, and he filed his income tax return for the calendar year 1941 with the collector of internal revenue for the fifth district of New Jersey.

He was the president and principal stockholder of the Newark Theatre Building Corporation, a New Jersey corporation. At the beginning of 1941 he owned 5,903 shares of a par value of $100 each, out of a total of 5,914 shares issued and outstanding. The authorized capital was 6,000 shares.

Petitioner and his brother were originally engaged in business together as partners. Later on they conducted their business affairs through corporations organized by them, and in connection with the financing of the Newark Theatre Building Corporation's operations both individuals guaranteed the indebtedness of that corporation secured by a mortgage on its property. In 1935 they divided their busi-

ness interests, and petitioner became the principal stockholder of the Newark corporation. Thereafter, his brother repeatedly demanded that he be relieved of his liability on the bonds. The Prudential Insurance Co., which held the mortgage, declined to release him, and petitioner foresaw the necessity of making other financial arrangements when the Prudential mortgage matured in 1941.

On December 6, 1940, the directors of the corporation met to consider the desirability of "revamping the capital structure of the company." The president pointed out that, in his opinion, the whole capital structure was not well balanced, and that it was not good business to have such a top-heavy capital set-up. He stated that a simple plan of recapitalization could be evolved which would bring about the desired change at comparatively little expense to the company; that he had consulted legal and accounting counsel, who could see no difficulty in consummating the plan of recapitalization.

The following plan was then proposed and adopted:

(1) A reduction in the authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares, or $591,400 are issued and outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value.

(2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of 6 percent per annum, payable semi-annually, the principal to be payable in 20 years from the date thereof, plus 5,914 shares of the new no par common stock, in exchange for the present shares of capital stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered.

The directors adopted the appropriate resolution to amend the certificate of incorporation to provide for the

reduction of authorized capital, and the issuance of no par value stock, and the stockholders duly ratified and approved the actions of the directors with respect thereto.

The purposes of the plan of recapitalization were: First, the saving of New Jersey franchise taxes in excess of $400 per year and, second, the reduction of the corporation's Federal income tax liability in substantial amounts each year by the deduction of the interest paid on the bonds.

The recapitalization was carried out in exact accordance with its terms. Petitioner surrendered his 5,903 shares of $100 par value stock, and received for each share thereof one share of no par value stock of a stated value of $50 and one $50 debenture bond. The bondholders were to rank *pari passu* with unsecured creditors in event of dissolution.

On the books of the corporation the old par capital stock account was debited with $591,400 and the new no par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "debentures payable" account. The surplus account was not affected.

Subsequently, petitioner gave to each of his two sons who worked with him in the business of the corporation debenture bonds of the face value of $24,000, or a total of slightly more than 16 per cent of his holdings.

The corporation's balance sheet as of December 31, 1940, was as follows:

ASSETS

Real Estate:			
Land, 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	245,926.20	227,008.80	
			$698,408.80
Land, 286-288 Market St.		[illegible]	
Building and improvements	91,214.88		
Less depreciation	44,333.41		
		46,881.47	
Equipment: Heating plant	718.72		
Less depreciation	479.13	239.59	
			155,121.06

Equipment:		
Theatre furniture and fixtures	61,703.37	
Less depreciation	56,230.87	
		5,472.50
Other:		
Cash in banks	$ 42,107.02	
Deposit a/c Gus Pappas	100.00	
Accrued interest receivable	77.81	
Unexpired insurance	503.66	
Rents receivable	635.00	
Notes receivable: Premier Amusement	41,500.00	
		84,923.49
Total assets		$943,925.85

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 60,000.00	
Mortgage payable, Prudential	231,250.00	
		$291,250.00
Accounts payable		1,031.75
Accruals:		
Federal capital stock tax	452.10	
Interest on mortgages	2,890.63	
Federal income and declared value excess profits tax	9,772.32	
		13,115.05
Total liabilities		$305,396.80

CAPITAL

Common stock	$591,400.00
Surplus: Donated surplus	1,500.00
Surplus	45,629.05
Total liabilities and capital	$943,925.85

Opinion.

The balance sheet as of December 31, 1941, was as follows:

ASSETS

Real estate:			
Land: 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	264,843.60	208,091.40	
			$679,491.40
Land: 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	48,061.53		
		43,153.35	
Equipment: Heating plant	718.72		
Less depreciation	527.05	191.67	
			151,345.02
			830,836.42
Other:			
Cash in bank		44,537.88	
Deposit, Gus Pappas Agent (a/c)		100.00	
Unexpired insurance		2,224.58	
Rents receivable		2,354.58	
Notes receivable (Premier Amusement Corp.)		38,000.00	
			87,217.04
Total assets			$918,053.46

LIABILITIES

Fixed:			
Mortgage payable, 286-288 Market St.		$ 56,000.00	
Mortgage payable, 193-195 Market St.		206,250.00	
			$262,250.00
Debentures payable			295,700.00
Current:			
Accounts payable		532.25	
Accrued taxes		281.25	
Accrued interest		4,056.63	
Reserve for Federal income tax (1940)		274.38	
Reserve for Federal income tax (1941)		4,843.13	
			9,984.64
Total liabilities			$567,934.64

CAPITAL

Common stock issued (5,914 no par shares)	$295,700.00
Surplus:	
Donated surplus	1,500.00
Net operating surplus	52,948.82
Total liabilities and capital	$918,053.46

The earnings and profits of the corporation up to December 31, 1941, accumulated after February 28, 1913, were $164,874.47, some of which had been capitalized by stock dividends declared in prior years.

The recapitalization above described was for the financial benefit of the corporation and had a legitimate business purpose.

OPINION.

KERN, *Judge:* The respondent has determined and now contends that petitioner received a taxable dividend, as the result of the exchange of old common stock for new common stock and debenture bonds of the Newark Theatre Building Corporation, to the extent of the latter's accumulated earnings, in the amount of $164,208.82. Respondent relies upon section 115 (a) and (g) of the Internal Revenue Code.[1]

[1] (a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

Petitioner surrendered stock having a par value of $590,300, and received in exchange therefor stock having a stated value of $295,150 and debenture bonds of the face value of $295,150. The corporate surplus remained untouched. The authorized capital was reduced to $295,700, and the balance of $295,700 formerly carried in the capital stock account was transferred to an account for the payment of the debenture bonds. No dividend was declared.

Both parties have briefed their contentions upon the assumption that if there was a recapitalization amounting to a reorganization under section 112 (g) (1) (E) of the Internal Revenue Code and an exchange of stock for stock and securities under section 112 (b) (3), then there could not be by that fact itself a taxable dividend resulting from the transaction. Accordingly, respondent contends that the transaction was not a non-taxable reorganization since it was not for any business purpose; while the petitioner contends that it was a recapitalization effected for legitimate business purposes and, therefore, a reorganization upon which no gain or loss should be recognized.

As we pointed out in *Edith B. Bass*, 45 B. T. A. 1117, 1119, the issue in a case such as this is not whether there was a taxable gain resulting from an exchange, but whether petitioner received a taxable dividend. While this is a correct statement of the issue, it does not make irrelevant the question of whether there was, in reality, a recapitalization. The facts which would be relevant in proving or disproving the existence of a bona fide recapitalization under the reorganization provisions of the code would also be relevant in proving or disproving that the same transaction amounted to a distribution of a taxable dividend. If facts tended to show the actual accomplishment of a recapitalization having legitimate business purposes, those same facts would tend to prove that the transaction was not the distribution of dividend under section 115 (g). Thus, if a corpora-

tion decided, for its own legitimate business purposes, to make adjustments in its capital structure, and did so in order to accomplish those purposes, it would be difficult to conclude that the transaction was also a distribution equivalent to a dividend undertaken for the benefit of its stockholders. See *Jacob Fischer*, 46 B. T. A. 999, 1011; *Alice H. Bazley*, 4 T. C. 897.

With this conception of the ultimate issue in mind, we proceed to a consideration of the question whether the transaction constituted, in reality, a recapitalization effected by the corporation for a legitimate business purpose.

The disposition of this question requires an examination of the purposes of the reorganization, as outlined by petitioner.

The first of these, designated as the "principal" purpose, was a belief that the existence of debenture bonds, available for use as collateral would facilitate the refinancing of the corporation's mortgage indebtedness, then impending. Petitioner testified that he believed debenture bonds might be more acceptable than common stock if additional collateral were required in negotiating a new loan. The refinancing arrangements were successfully completed, but the record is completely silent as to whether the bonds were used in that connection. We may fairly assume, therefore, that they were not.

We are not impressed with the validity or the existence of this alleged purpose. It is difficult to see how debenture bonds of this nature, inferior to the mortgage lien itself, would have been as attractive to a mortgage bondholder of the corporation as common stock, which would at least have provided the creditor, already secured by a mortgage on the debtor's property, with some additional security in the form of a voice in the management of the corporation in event of default and pending foreclosure.

The second reason for the reorganization, according to petitioner, was his desire to give some securities of the corporation to his two sons, who were associated with him in the business of the corporation, without surrendering any of his stock control over the company. He did give them bonds of a total face value of $48,000, representing about 16 per cent of his holdings. This was obviously a personal reason having no connection with the corporate business.

The remaining two reasons may be considered together. They were the saving of corporate income tax resulting from the right to deduct interest paid on the bonds, and saving of New Jersey franchise tax resulting from the decrease in the amount of stock. The total amount of the savings to the corporation was not computed, but it is apparent they are and will be substantial in each of the corporation's future tax years during the life of the bonds.

Respondent attacks these purposes as insufficient. It is true that the courts have held that where a recapitalization serves no legitimate corporate purpose, but is undertaken solely for the individual benefit of the stockholders, an exchange of securities made pursuant thereto is not excepted from taxation. See *Arthur S. Kleeman*, 35 B. T. A. 17; *Gregory* v. *Helvering*, 293 U. S. 465; *Royal Marchet*, 32 B. T. A. 72; *Louis Wellhouse*, 3 T. C. 333. Where the sole purpose is to minimize the taxes of the corporation's stockholders this rule would be pertinent.

But this case may be sharply distinguished in the essential particular that here, the object sought was the minimizing of the taxes of the corporation itself. This situation can and must be distinguished from cases where the reorganization is designed for the individual benefit of the stockholders, without resulting benefit to the corporation. The purpose here was to so arrange the corporation's financial structure that its future tax liability would be reduced.

Opinion.

We have recognized as a legitimate corporate purpose the reduction of the corporation's liability for dividends on preferred stock. In *Annis Furs, Inc.*, 2 T. C. 1096, we considered the reduction of the corporation's periodic charge from 6½ per cent (the dividend on the preferred stock exchange for debenture bonds) to 6 per cent (the interest in the bonds) as a sufficient financial advantage to the corporation to serve as a legitimate business purpose.

The reduction or elimination of other items of expense, by legal methods, is not essentially different. Any reduction of expense results in increased profits, and the primary purpose of all commercial corporations is the realization of profit.

We have already recognized that a reduction in the tax liability of a corporation may constitute a legitimate business purpose of a reorganization under the statute. *Clarence J. Schoo*, 47 B. T. A. 459. In that case two of the three reasons given for the recapitalization there in issue had to do with reductions in tax liability. Yet we said in part in our opinion:

> There is nothing in the circumstances to invite the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465. No transaction was impending which threatened a tax on any of the participants. The recapitalization is not a sham or an artificial detour around a taxable event. There is nothing to indicate that a devious form of corporate maneuvering was masquerading as a recapitalization in order to avoid a tax which would have been assessed if the transaction had been permitted to take its direct course.

See also *C. A. Monroe*, 39 B. T. A. 685; *Tower* v. *Commissioner*,—Fed. (2d)—(C. C. A., 6th Cir., 4/2/45).

There is no evidence, and no contention, that this exchange was not in fact made, that the old stock was not really canceled, or that the debenture bonds here do not represent a genuine indebtedness. The business of the corporation continued to be carried on. There is no element of unreality or sham apparent anywhere in the record. The

facts of *Gregory* v. *Helvering, supra,* bear so little resemblance to the facts of this case that the rule there announced is inapplicable here. It can not be considered as authority for any rule that a corporation may not rearrange its capital structure, in exact accordance with the statute, in such a way as to secure *for itself in the future* whatever benefits it may be entitled to under the existing tax laws.

The case of *Crown Cork International Corporation,* 4 T. C. 19, is distinguishable on its facts. There it was held that a purported sale of securities by a parent corporation to a wholly owned subsidiary for the purpose of realizing a loss for tax purposes was, in reality, no sale, but a sham. The controlling fact in that case was that the "vendor" so controlled the "vendee" that there was, in reality, no such final disposition of the securities transferred as to justify a conclusion that there was a sale which would give rise to a tax loss. If there had been a final disposition of the securities transferred, e. g., a transfer to a corporation in no way controlled by the transferor, a sale would have been recognized for tax purposes even though the sole purpose of making the sale on the part of the transferor was to enable it to take a deduction on account of a loss.

We conclude that there was in this case a bona fide recapitalization of the corporation accomplished for its benefit and having a legitimate business purpose; that the transaction here in question was undertaken for the purpose of effecting that recapitalization; and that it was not undertaken for the purpose of effecting the distribution of a dividend to the stockholders of the corporation.

Therefore, and upon a consideration of all of the facts disclosed by the record, we are of the opinion that respondent erred in his determination that the issuance of debenture bonds to petitioner constituted a taxable dividend.

Decision will be entered under Rule 50.

Opinion.

5 T. C. No. 40.

THE TAX COURT OF THE UNITED STATES

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 4109. Promulgated June 29, 1945.

Debentures distributed to petitioner by corporation of which he was principal common stockholder in connection with elimination of old common stock and issuance of new without par value, *held*, on facts failing to show corporate business purpose for the transaction, to constitute a taxable dividend to the extent of their value and of the corporation's accumulated earnings, notwithstanding that surplus account remained unchanged on corporate books.

SYDNEY A. GUTKIN, ESQ., for the petitioner.

JONAS M. SMITH, ESQ., ESQ., for the respondent.

Respondent determined a deficiency in petitioner's income tax for the calendar year 1941 in the amount of $113,021.44.

Aside from one small item not in dispute the deficiency results from respondent's finding that an exchange by petitioner of common stock of the Newark Theatre Building Corporation for new common stock and debenture bonds of the same corporation in January, 1941, in connection with the plan of recapitalization of that company resulted in the distribution of a dividend to petitioner constituting fully taxable income.

The petitioner contends that the transaction was a recapitalization and reorganization within the meaning of

section 112 of the Internal Revenue Code and was not a distribution of a dividend; and, in the alternative, he contends that there was a loss from the transaction rather than a gain, that if there was a gain it was taxable as a capital gain, and that if it is to be treated as a dividend, it was a dividend of no value.

FINDINGS OF FACT.

Petitioner is an individual residing in New Jersey, and he filed his income tax return for the calendar year 1941 with the collector of internal revenue for the fifth district of New Jersey.

He was the president and principal stockholder of the Newark Theatre Building Corporation, a New Jersey corporation. On January 26, 1941, he owned 5,903 shares of a par value of $100 each, out of a total of 5,914 shares issued and outstanding. The authorized capital was 6,000 shares.

Petitioner and his brother were originally engaged in business together as partners. Later on, they conducted their business affairs through corporations organized by them, and in connection with the financing of the Newark Theatre Building Corporation's operation, both individuals guaranteed the indebtedness of that corporation secured by a mortgage on its property. In 1935, they divided their business interests, and petitioner became the principal stockholder of the Newark corporation. Thereafter, his brother repeatedly demanded that he be relieved of his liability on the bonds. The Prudential Insurance Co., which held the mortgage, declined to release him, and petitioner foresaw the necessity of making other financial arrangements when the Prudential mortgage matured in 1941.

On December 6, 1940, the directors of the corporation met to consider the desirability of "revamping the capital

structure of the company." The president pointed out that, in his opinion, the whole capital structure was not well balanced, and that it was not good business to have so top-heavy a capital set-up. He stated that a simple plan of recapitalization could be evolved which would bring about the desired change at comparatively little expense to the company; that he had consulted legal and accounting counsel, who could see no difficulty in consummating the plan of recapitalization.

The following plan was then proposed and adopted:

(1) A reduction in the authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares, or $591,400 are issued and outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value.

(2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of 6 per cent per annum, payable semi-annually, the principal to be payable in 20 years from the date thereof, plus 5,914 shares of the new no-par common stock, in exchange for the present shares of capital stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered.

The directors adopted the appropriate resolution to amend the certificate of incorporation to provide for the reduction of authorized capital, and the issuance of no-par value stock, and the stockholders duly ratified and approved the actions of the directors with respect thereto.

It was anticipated that there would be a saving of New Jersey franchise taxes in excess of $400 per year and a reduction of the corporation's Federal income tax liability in substantial amounts each year by the deduction of the interest paid on the bonds.

Opinion.

The recapitalization was carried out in exact accordance with its terms. Petitioner on January 27, 1941, surrendered his 5,903 shares of $100 par value stock, and received for each share thereof one share of no-par value stock of a stated value of $50, and one $50 debenture bond. The bondholders were to rank *pari passu* with unsecured creditors in event of dissolution.

On the books of the corporation, the old par capital stock account was debited with $591,400, and the new no-par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The surplus account was not affected.

Subsequently, petitioner gave to each of his two sons who worked with him in the business of the corporation debenture bonds of the face value of $24,000, or a total of slightly more than 16 per cent of his holdings. He duly reported these transfers for gift tax purposes and attributed to the bonds their full face value, paying gift tax thereon.

The corporation's balance sheet as of December 31, 1940, was as follows:

	ASSETS		
Real Estate:			
Land, 193-195 Market St.		$471,400.00	
Buildings	$472,535.00		
Less depreciation	245,926.20	227,008.80	
			$698,408.80
Land, 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	44,333.41		
		46,881.47	
Equipment: Heating plant	718.72		
Less depreciation	479.13	239.59	
			155,121.06

Equipment:		
Theatre furniture and fixtures	61,703.37	
Less depreciation	56,230.87	
		5,472.50
Other:		
Cash in banks	$ 42,107.02	
Deposit a/c Gus Pappas	100.00	
Accrued interest receivable	77.81	
Unexpired insurance	503.66	
Rents receivable	635.00	
Notes receivable: Premier Amusement	41,500.00	
		84,923.49
Total assets		$943,925.85

LIABILITIES

Fixed:		
Mortgage payable, 286-288 Market St.	$ 60,000.00	
Mortgage payable, Prudential	231,250.00	
		$291,250.00
Accounts payable		1,031.75
Accruals:		
Federal capital stock tax	452.10	
Interest on mortgages	2,890.63	
Federal income and declared value excess profits tax	9,772.32	
		13,115.05
Total liabilities		$305,396.80

CAPITAL

Common stock	$591,400.00
Surplus—Donated surplus	1,500.00
Surplus	45,629.05
Total liabilities and capital	$943,925.85

Opinion.

The balance sheet as of December 31, 1941, was as follows:

ASSETS

Real estate:			
Land: 193-195 Market St.		$471,400.00	
Buildings	$472,935.00		
Less depreciation	264,843.60	208,091.40	
			$679,491.40
Land: 286-288 Market St.		108,000.00	
Building and improvements	91,214.88		
Less depreciation	48,061.53		
		43,153.35	
Equipment: Heating plant	718.72		
Less depreciation	527.05	191.67	
			151,345.02
			830,836.42
Other:			
Cash in bank		44,537.88	
Deposit, Gus Pappas Agent (a/c)		100.00	
Unexpired insurance		2,224.58	
Rents receivable		2,354.58	
Notes receivable (Premier Amusement Corp.)		38,000.00	
			87,217.04
Total assets			$918,053.46

LIABILITIES

Fixed:			
Mortgage payable, 286-288 Market St.		$ 56,000.00	
Mortgage payable, 193-195 Market St.		206,250.00	
			$262,250.00
Debentures payable			29,700.00

Current:		
Accounts payable	532.25	
Accrued taxes	281.25	
Accrued interest	4,056.63	
Reserve for Federal income tax (1940)	274.38	
Reserve for Federal income tax (1941)	4,840.13	
		9,984.64
Total liabilities		$567,934.64

CAPITAL

Common stock issued (5,914 shares N. P. V.)	$295,700.00
Surplus:	
Donated surplus	1,500.00
Net operating surplus	52,918.82
Total liabilities and capital	$918,053.46

The earnings and profits of the corporation accumulated since February 28, 1913, and up to December 31, 1940, were $157,225.05, and up to December 31, 1941, were $164,874.47, of which $111,596 had been capitalized by stock dividends declared in prior years. The accumulated earnings and profits of the corporation available for distribution on January 26, 1941, were not less than $164,514.82.

The debentures regularly earned and paid the interest due on them.

The debentures received by petitioner had a value when received of not less than $164,208.82.

The recapitalization and distribution of debentures above described had no legitimate business purpose.

OPINION.

OPPER, *Judge:*

An opinion in this proceeding was promulgated on April 26, 1945, (4 T. C. No. 140) which, pursuant to subse-

quent order, was referred to the Court for review and which is to be considered superseded by the present opinion.

As in *Alice H. Bazley, et al.*, 4 T. C. 897, the first question for disposition here is whether the non-recognition provisions of section 112 are applicable to the receipt by petitioner of debentures in a transaction involving the cancellation of previously outstanding common stock and the issuance of new no-par common. This in turn depends upon whether we can find as a fact that there was a legitimate purpose of the corporate business for the distribution to petitioner of the debentures.

The resolution of this problem requires an examination of the purposes of the "reorganization," as presented by petitioner. The first of these, designated as the "principal" purpose, was a belief that the existence of debenture bonds, available for use as collateral, would facilitate the refinancing of the corporation's mortgage indebtedness, then impending. Petitioner testified that he believed debenture bonds might be more acceptable than common stock if additional collateral were required in negotiating a new loan. The refinancing arrangements were successfully concluded, but the record is completely silent as to whether the bonds were used in that connection. We may fairly assume, therefore, that they were not.

We are not impressed with the validity or the existence of this alleged purpose. It is difficult to see how debenture bonds of this nature, inferior to the mortgage lien itself, would have been as attractive to a mortgage bondholder of the corporation as common stock, which would at least have provided the creditor, already secured by a mortgage on the debtor's property, with some additional security in the form of a voice in the management of the corporation in the event of default and pending foreclosure.

The second reason for the "reorganization," according to petitioner, was his desire to give some securities of the

corporation to his two sons, who were associated with him in the business of the corporation, without surrendering any of his stock control over the company. He did give them bonds of a total face value of $48,000, representing about 16 per cent of his holdings. This was obviously a personal reason having no connection with the corporate business.

The remaining two reasons may be considered together. They were the saving of corporate income tax resulting from the right to deduct interest paid on the bonds, and the saving of New Jersey franchise tax resulting from the decrease in the amount of stock. These purposes are equally unavailable when considered from the standpoint of the corporate business. As a result of the procedure adopted, the corporation undertook an annual obligation of 6 per cent of $295,150 in interest charges in order to secure the reduction of a few hundred dollars in state franchise taxes and of an indeterminate amount of Federal income tax which would necessarily be less than the interest obligation. If the money were to be borrowed from strangers, it seems evident that this could not but be a losing transaction for the corporation. As we said in *De Nobili Cigar Co.*, 1 T. C. 673, 679, affirmed (C. C. A., 2nd Cir.), 143 Fed. (2d) 436:

> * * * no explanation is offered why it was necessary, or even sound policy from the corporation's point of view, to capitalize earnings * * * and thus to pay 6 per cent for the use of funds which petitioner [the corporation] was already free to use * * *

See *Talbot Mills*, 3 T. C. 95, affirmed (C. C. A., 1st Cir.), 146 Fed. (2) 809, certiorari granted, U. S. (April 30, 1945).

That the dominant stockholder rather than a stranger happened to be the person to whom the interest would be

paid can account for the company so conducting itself in spite of the disadvantage to it. But while furnishing an explanation for the action, it offers no evidence of any independent benefit to the corporation itself as distinguished from the reciprocal advantage to petitioner as an individual from the receipt of the interest payments, and thus falls short of constituting the corporate business purpose which we are required to find in such cases. *Gregory* v. *Helvering*, 293 U. S. 465; *Alice H. Bazley, supra.*

Once the transaction is removed, as we accordingly think it must be, from the scope of section 112, a distribution of the corporation's debentures can partake of the nature of a taxable dividend to the same extent as any other distribution of property or of the stock of a wholly different corporation. *Doerschuck* v. *United States* (D. C. E. D. N. Y.), 274 Fed. 739; see *Peabody* v. *Eisner*, 247 U. S. 347. Our inquiry is then directed to whether under the provisions of section 115 (g) the distribution was essentially equivalent to a taxable dividend. *Edith B. Bass*, 45 B. T. A. 1117, reversed (C. C. A., 1st Cir., 129 Fed. (2d) 300. The contention is made that because the corporation's book surplus was undisturbed there could have been no dividend distribution.[1] For that position, to be sure, the reversal in *Edith B. Bass, supra*, can be cited as at least partial authority. With the greatest deference, however, we remain of the opinion that the decision of the Board of Tax Appeals in that case was correct, and we feel obliged to adhere to it rather than to follow the reasoning of the opinion of reversal.

The argument that by a bookkeeping entry purporting to make a distribution from capital and without disturbing earned surplus a corporation can be held to have accomplished that result seems to us to lose sight of the express

[1] A similar argument was made in *Alice H. Bazley, supra*, but we found it unnecessary to deal with it under the facts there brought forth.

statutory provision and to treat as cause what is in reality effect. Except for a distribution in liquidation, we must start with the premise that "every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits" because the statute so commands in unmistakable language.[2] We do not understand there is any suggestion that these were distributions in liquidation and nothing in the record warrants the assumption that they were. Internal Revenue Code, section 115 (c) and (i). If as a consequence there were earnings and profits, the distribution was a dividend or its essential equivalent, and the effect upon the corporation's earned surplus for purposes of future tax computation would be to reduce it regardless of the treatment of that surplus on the corporation's books. Cf. *Commissioner* v. *Bedford Estate*, U. S. (May 21, 1945); *August Hormann*, 34 B. T. A. 1178. "* * * 'earnings and profits' in the tax sense although it does not correspond exactly to taxable income does not necessarily follow corporate accounting concepts either." *Wheeler* v. *Commissioner*, U. S. (March 26, 1945). We are accordingly unable to agree that the mere dealing with the capital account in such a way that the distribution is treated on the corporate books as a diminution of capital rather than of earned surplus can have any binding influence on the determination which we are required to make. That is the effect of *Edith B. Bass*, *supra*, where we said, page 1121:

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[2] Internal Revenue Code section 115(b)

"(b) SOURCE OF DISTRIBUTIONS.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated or increase in value of property accrued before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113."

Opinion.

> * * * The issuance of the preferred stock in the present case gave to the recipients an interest different from that represented by their former stockholdings. That was the intent and purpose of the change. The corporation had more than sufficient earnings accumulated after February 28, 1913, to pay a dividend equal to the value of this preferred stock. The petitioner concedes that the issuance of stock involving the capitalization of earnings could result in a taxable dividend, but contends that this was a "split-up" involving merely a change in the character and number of shares by which existing capital continued to be represented and was not a taxable dividend. It is immaterial that the corporation did not capitalize any earnings to support the issuance of the preferred stock, since section 115 (b) provides that "every distribution is made out of earnings or profits to the extent thereof." * * *

This statement seems warranted by the observation in *Helvering* v. *Gowran*, 302 U. S. 238, that

> * * * under section 115 (b) * * * (the distribution of preferred stock) was presumed to have been made "out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits." In no sense, therefore, can it be said to have been "held" by Gowran prior to its declaration. Since the proceeds were therefore not "capital gains" they were taxable at the normal and surtax rates applicable to ordinary income.

Having found, as we think we must, that such earnings as the corporation had were distributed by means of the debentures to the extent of their value, it becomes neces-

sary to examine the amount of those earnings and the fair market value of the debentures. The outer limit of taxability in that event will be the fair market value of the property received[3] under section 115 (j) and the amount of earnings and profits of the corporation available for distribution[4] under section 115 (a). On the first subject it is conceded that the corporation had undistributed earnings as of the close of the year 1940 of $45,629.05. In addition there had been deductions from earned surplus on account of the distribution of prior nontaxable stock dividends in the amount of $111,596, which must be added to the corporate earnings available for distribution. *August Horrmann, supra.* The distribution was not made on December 31, 1940, however, but on January 26, 1941. There is no evidence whatever from which we can determine what earnings and profits were available on that date. Respondent has found them to be a figure somewhat, though slightly, less than the amount shown on the balance sheet as of the end of the current year. Under the circumstances we cannot say that petitioner has sustained his burden of proving that respondent's determination was erroneous in this respect. *Dorothy Whitney Elmhirst*, 41 B. T. A. 348, 354-360.

Similarly, the fair market value of the debentures is in effect conceded to be their face amount, although petitioner

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[3] Internal Revenue Code, section 115(j).

"(j) VALUATION OF DIVIDEND.—If the whole or any part of a dividend is paid to a shareholder in any medium other than money, the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder."

[4] Internal Revenue Code, section 115(a).

"(a) DEFINITION OF DIVIDEND.—The term 'dividend' when used in this chapter (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

contends that the common stock was thereby reduced drastically below its original basis to him. But the debentures carried interest which has been duly met, and were a claim to corporate assets which took preference over that of the stockholders. To say nothing of petitioner's own contemporaneous gift tax valuation, the corporate assets, even at petitioner's present figure, are sufficient to justify our finding of the value of the debentures from the standpoint of collectibility upon default. Although these figures are strenuously contested by respondent, who insists that the corporate assets were of sufficient value to cover both the debentures and petitioner's original basis for the stock, we are mindful that this is not a gain or loss situation and requires no determination as to the value of the stock. *Edith B. Bass, supra,* refers to the

> * * * opinions in *United States* v. *Phellis*, 257 U. S. 156, and *Rockefeller* v. *United States*, 257 U. S. 176, in which the Court had said that the test of taxability of a corporate distribution lies in its effect upon the individual stockholder rather than upon the corporation or the stockholders as a group, and it does not matter that the value of the stock on which the distribution was made was thereby decreased. The normal result of declaring a dividend of any kind is to reduce the value of stock theretofore outstanding. * * *

If the debentures were worth at least as much as the corporation's earned surplus, which they undoubtedly were, respondent's determination must be sustained and any further discussion is beyond the necessary confines of the present question. In the light of those circumstances we have found as a fact only that the fair market value of the debentures was at least as great as the dividend determined

by respondent to have been received. It follows that respondent's determination must be sustained in the amount found by him.

Reviewed by the Court.

Decision will be entered for the respondent.

KERN, *J.*, dissenting:

A reduction in the tax liability of a corporation may constitute a legitimate business purpose of a reorganization under the statute. *Clarence J. Schoo*, 47 B. T. A. 459. See also, *C. A. Monroe*, 39 B. T. A. 685; *Toner v. Commissioner*, Fed. (2) , (CCA-6, April 2, 1945). A reduction in the corporation's liability for dividends or interest also constitutes a legitimate business purpose. *Annis Furs, Inc.*, 2 T. C. 1096. However, the majority opinion holds that where the reduction in the corporation's tax liability is accompanied by an increase in liability for interest in an equal or greater amount, the reduction in tax liability cannot be said to be a legitimate business purpose.

With this I am unable to agree. A realistic view of the ultimate purpose of a private corporation is that it is to make money for the investors who have contributed their capital to it, and to distribute to them as much as possible and practical out of its gross income. Under the facts of the instant case, it is apparent that after the recapitalization in question, petitioner, as an investor of the corporation, would receive a greater distribution of money in the form of dividends and interest than he received as dividends before the recapitalization. Therefore, the recapitalization contributed to the business purpose of the corporation and must be considered as a legitimate business purpose.

Since, in my opinion, the adjustments made by the corporation in its capital structure were for the purpose of

accomplishing a legitimate business purpose, I am unable to conclude that the transaction was also a distribution equivalent to a dividend. See *Jacob Fisker*, 46 B. T. A. 1011.

SMITH, *J.*, agrees with this dissent.

ARUNDELL, *J.*, dissenting:

It was my understanding that the so-called corporate reorganization provisions of the revenue acts were designed to permit some flexibility in the financial set-up of corporations without the present imposition of a tax due to such changes. It was recognized that our capitalistic economy could not properly function if it was kept in a strait-jacket, as it most surely would be if a tax consequence resulted with every change in the financial structure. Thus, recapitalizations were permitted without the present recognition of tax, leaving the imposition of the tax to the time when the exchanged security should be finally disposed of. No one contends that if the recapitalization is, in fact, a fraud or a sham it is to be recognized, but I do not understand the majority would characterize what has taken place as falling within either category. Debenture bonds have taken the place of common stock and that change in capitalization was what the directors desired and that is what they accomplished. There has been a permanent change in the capital structure, and it is the receipt of these very debentures by a stockholder which, the majority hold, constitutes a taxable dividend.

But, it is said that there was no "legitimate" reason for this recapitalization. Certainly what was done was legitimate in the sense that it was lawful. Many corporations are originally organized in the same way that this corporation was "reorganized"; and if it had been initially capi-

talized in the identical way that it is today, it would be subject to no criticism. Surely it was never intended that the tax collector or, indeed, a member of this court should pass on the wisdom or desirability of a corporate recapitalization. If what was done here was genuine and was not a sham, the test of the statute has been met. I think *Buss v. Commissioner*, 129 Fed. (2d) 308, supports the view here expressed.

SMITH, BLACK, HILL and KERN, *JJ.*, agree with this dissent.

Decision.

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, promulgated June 29, 1945, it is ORDERED and DECIDED: That there is a deficiency in income tax of $113,021.44 for the calendar year 1941.

Entered June 29, 1945.

(Signed) CLARENCE V. OPPER,
Judge.

(Seal)

Proceedings.

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9069 October Term, 1945.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

And afterwards, to wit, 7th day of February, 1946, come the parties aforesaid by their counsel aforesaid, and this case, being called for argument sur pleadings and briefs, before the Honorable Albert B. Maris, Honorable Herbert F. Goodrich and Honorable John J. O'Connell, Circuit Judges, and the Court not being fully advised in the premises, takes further time for the consideration thereof.

Order.

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9069.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Present: MARIS, McLAUGHLIN and O'CONNELL, Circuit Judges.

It is hereby ORDERED that the above entitled case be restored to the argument list for the current term for reargument before the court *en banc*.

By the Court,

MARIS,
Circuit Judge.

February 15, 1946.

Endorsements—

Order Restoring Case to Argument List for Reargument before the Court *en banc*.
Received & Filed Feb. 15, 1946,
Wm. P. Rowland, Clerk.

Opinion of the Court.

(Filed April 16, 1946).

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9969 October Term, 1945.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ON APPEAL FROM DECISION OF THE TAX COURT OF THE UNITED STATES.

Argued February 7, 1946.

Reargued March 5, 1946.

Before BIGGS, MARIS, GOODRICH, McLAUGHLIN and O'CONNELL, *Circuit Judges*.

By O'CONNELL, *Circuit Judge*.

Basically, this case presents the same issues as *Bazley v. Commissioner*, C. C. A. 3, April 1946. There are two factual differences, however, which call for further consideration. As in Bazley, we have before us a petitioner who is the principal shareholder[1] of a tightly held corporation.

The taxpayer, in connection with the elimination of old common stock and the issuance of new without par value,

[1] Petitioner held 5,993 out of a total of 5,914 shares outstanding. The authorized capital was 6,000 shares of $100 par value.

received debentures distributed by the corporation.[2] The bonds were worth not less than $164,208.82, and regularly earned and paid the interest due on them. At the time of their distribution, the corporation had accumulated earnings and profits since February 28, 1913, in a sum at least equal to $164,514.82.[3] The corporate books showed no change in its surplus account following or as a result of the distribution of the bonds.[4]

The Tax Court found there was no legitimate reorganization within the meaning of the Revenue Code, Section 112,[5] and that this was a distribution "essentially equivalent to a taxable dividend"; Section 115 (g).[6]

Both conclusions are challenged. We are urged to reverse the Tax Court on the ground that there is here a legitimate reorganization because it was undertaken to save an annual New Jersey franchise tax in the amount of $400 and achieve a saving in corporate income tax resulting from the right to deduct interest paid on the bonds. The Tax Court took a rather skeptical view of these so-called reasons for the reorganization, pointing out the obvious financial disadvantage to the corporation in agreeing to pay a huge interest charge on almost $300,000 worth of debenture

[2] The following "plan of reorganization" was consummated: (1) A reduction in authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares of $591,400 were issued and outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value. (2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of 6 per cent per annum, payable semi-annually, the principal to be payable 20 years from the date thereof, plus 5,914 shares of the new no-par common stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered. There was compliance with the provisions of the New Jersey law regarding such corporate transactions.

[3] $111,596 had been capitalized by stock dividends declared in prior years.

[4] The old par capital stock account was debited with $591,400 and the new no par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The surplus account was not affected.

[5] 26 U. S. C. (1940 ed.) Sec. 112; 26 U. S. C. A. Sec. 112

[6] 26 U. S. C. (1940 ed.) Sec. 115 (g); 26 U. S. C. A. Sec. 115 (g).

bonds to achieve a reduction in corporate tax liability of a much lesser sum. It concluded that the "recapitalization" and distribution of debentures" by the corporation "had no legitimate business purpose."

We agree with this conclusion. In *Bazley*, we pointed out that Congress did not intend to exempt all "reorganizations" from tax consequences. Only those "required by business exigencies" or "undertaken for reasons germane to the continuance of the corporation" allegedly reorganized may qualify for the exemption.[7] The intent of Congress in allowing Section 112 to remain in the 1934 Revenue Act was to permit, tax free, "legitimate reorganizations required in order to strengthen the financial condition of the corporation. * * *"[8] In the light of these requirements, we believe the Tax Court, applying the proper criterion, reached the correct conclusion. This was not the kind of corporate reorganization which Congress intended to make tax free.

We come now to the second point of departure. The precise question is whether the Tax Court's conclusion that this was a distribution essentially equivalent to a distribution of a taxable dividend may stand in view of the absence of a corresponding reduction in the surplus account. In determining tax liability, bookkeeping entries are not necessarily conclusive. Income tax liability does not stand or fall with the particular method adopted by corporate accountants in reflecting transactions under scrutiny. Here again, actions count. What was accomplished by the transaction? The Tax Court inquired and found that what appears to be a distribution out of capital is in reality made out of accumulated earnings and profits. If over the years since February 28, 1913, the corporation piled up earnings

[7] Treasury Regulations 103, Sec. 19.112 (g)-1, Sec. 19.112 (g)-2.

[8] See Report by Chairman Doughton of the House Ways and Means Committee, accompanying the submission of the Revenue Act of 1934 (H. No. 704, 73d Cong., Second Session).

and, *qua bookkeeping*, imprisoned them in the capital account through the issuance of non-taxable stock dividends,[9] a subsequent distribution in money or bonds of an amount not in excess of such accumulated earnings and profits can partake of the quality of a dividend distribution: Section 115 (b),[10] "every distribution is made out of earnings or profits to the extent thereof." Corporate accounting concepts are not controlling: *Commissioner* v. *Estate of Bedford*, 325 U. S. 283 (1945); *Commissioner* v. *Wheeler*, 324 U. S. 542 (1945); *cf. Helvering* v. *Gowran*, 302 U. S. 238 (1937).

Once it is concluded that the debentures were distributed out of earnings or profits accumulated since February 28, 1913, taxation must result. To hold otherwise would be to permit, by means of bookkeeping entries, the use of the Section 112 exemption as a device to evade the payment of income tax as required under Section 115: *cf. Commissioner* v. *Fisher*, U. S. Sup. Ct., March 11, 1946.

In the last analysis, this case turns on a dispute over proper accounting procedure for income tax collection purposes. We are not at liberty to treat as a question of law such a dispute. It is patently controlled by the Dobson rule.

Affirmed.

MARIS and GOODRICH, *Circuit Judges*, dissenting.

Maris and Goodrich, Circuit Judges, dissent for the reason set out in their dissenting opinion in the case of *Bazley* v. *Commissioner*, ... F. (2d) ...

[9] *Cf. Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

[10] 26 U. S. C. (1940 ed.) Sec. 115 (b); 26 U. S. C. A. Sec. 115 (b).

A true Copy:

Teste:

Clerk of the United States Circuit Courts of Appeals for the Third Circuit.

Judgment.

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS.

FOR THE THIRD CIRCUIT.

No. 9069 October Term, 1945.

ADAM A. ADAMS, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Present: BIGGS, MARIS, GOODRICH, McLAUGHLIN and O'CONNELL, *Circuit Judges*.

Appeal from the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

By the Court,

JOHN J. O'CONNELL,
Circuit Judge.

April 16, 1946.

Endorsements—

Order Affirming Decision of the Tax Court.
Received & Filed April 16, 1946,
Wm. P. Rowland, Clerk.

Certificate.

UNITED STATES OF AMERICA,
Eastern District of Pennsylvania,
Third Judicial Circuit.

I, WM. P. ROWLAND, Clerk of the United States Circuit Court of Appeals for the Third Circuit, DO HEREBY CERTIFY the foregoing to be a true and faithful copy of the original Appendix to Petitioner's Brief, as constituting the portions of the record before this court at argument; and proceedings in this court, in the case of Adam A. Adams, Petitioner, vs. Commissioner of Internal Revenue, Respondent, No. 9069, on file, and now remaining among the records of the said Court, in my office.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed the seal of the said Court, at Philadelphia, this 15th day of May in the year of our Lord one thousand nine hundred and forty six, and of the Independence of the United States the one hundred and seventieth.

(S) WM. P. ROWLAND,
Clerk of the U. S. Circuit Court of Appeals,
Third Circuit.

(Seal)

SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1946

No. 269

ORDER ALLOWING CERTIORARI—Filed October 14, 1946

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

No 20

Office - Supreme Court, U. S.
FILED
JUN 18 1945
CHARLES ELMORE CROPLEY
CLERK

Supreme Court of the United States

ADAM A. ADAMS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT THEREOF.

SYDNEY A GUTKIN,
Attorney for and of Counsel with Petitioner,
744 Broad Street,
Newark 2, New Jersey.

Arthur W. Cross, Inc., Law Printers, 71-73 Clinton Street, Newark 5, N. J.

INDEX

	PAGE
PETITION FOR WRIT OF CERTIORARI	1
A. Summary and Short Statement of the Matter Involved	1
B. Jurisdiction	6
C. Questions Presented	7
D. Reasons Relied Upon for Allowance of Writ	8
BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI	11
I. Opinions of the Courts Below	11
II. Jurisdiction	12
III. Statement of the Case	12
IV. Specification of Errors	12
V. The Argument	14
Point A. The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case.	14

PAGE

Point B. The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose to be within Sections 112 (g) (1) (E) and 112(b) (3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering*, 293 U. S. 465 (1935). 19

Point C. The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b) (2), 112(c) (1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b) (3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss... 24

Point D. The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111; 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941. .. 26

PAGE

Point E. The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court. 30

CONCLUSION 31

ADDENDUM 32

CASES CITED

Bass v. *Commissioner*, 129 F. (2d) 300 (C. C. A. 1st, 1942), reversing 45 B. T. A. 1117 (1941) 8, 15, 18

Bazley v. *Commissioner*, F. (2d) (C. C. A. 3rd, 1946). 19

Commissioner v. *Estate of Bedford*, 325 U. S. 283 (1945). 16

Commissioner v. *Kelley Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944), rev'd., 66 S. Ct. 299 (1946). 30

Commissioner v. *Wheeler*, 324 U. S. 542 (1945). ... 16

Doerschuck v. *United States*, 274 Fed. 739 (D. C. E. D. N. Y., 1921). 16

Eisner v. *Macomber*, 252 U. S. 189 (1920) 8, 31

Gregory v. *Helvering*, 293 U. S. 465 (1935). 8, 19

Helvering v. *Gowran*, 302 U. S. 238 (1937). 16

Helvering v. *Griffiths*, 318 U. S. 371 (1943). 10, 17, 31

Leland v. *Commissioner*, 50 F. (2d) 523 (C. C. A. 1st, 1931). 18

Peabody v. *Eisner*, 247 U. S. 347 (1918). 16

Strassburger v. *Commissioner*, 318 U. S. 604 (1943). 8, 31

Wellhouse, Louis, Jr., 3 T. C. 363 (1944) 19

CONSTITUTION AND STATUTES

PAGE

Constitution of the United States:
Sixteenth Amendment 32

Internal Revenue Code:

Section 22 ..... 10, 30, 32
Section 111 ..... 9, 13, 26, 27, 29, 32
Section 112(a) 26, 29, 33
Section 112(b) (2) 7, 9, 13, 24, 25, 26, 33
Section 112(b) (3) 9, 13, 17, 19, 24, 25, 26, 33
Section 112(c) (f) 9, 13, 24, 25, 33
Section 112(e) 9, 13, 24, 25, 26, 34
Section 112(g) 7, 8, 9, 13, 19, 26, 34
Section 115(a) 14, 15, 34
Section 115(b) 17, 35
Section 115(c) 35
Section 115(g) 7, 15, 35
Section 117 ..... 9, 13, 26, 27, 29, 35

Judicial Code, 43 Stat. 938, Sec. 240(a) (U. S. C. A., Title 28, Sec. 347) 7

Petition for Writ of Certiorari.

Supreme Court of the United States

OCTOBER TERM, 1945.

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

To the Honorable The Supreme Court of the United States:

Your petitioner, Adam A. Adams, prays that a Writ of Certiorari issue to review the order of the United States Circuit Court of Appeals for the Third Circuit, entered after reargument before the Court *en banc*, affirming the order of the Tax Court of the United States, pursuant to which a deficiency in petitioner's income tax for the calendar year 1941 was found in the amount of $113,021.44.

A.

Summary and Short Statement of the Matter Involved.

1. The facts as found and considered by the Tax Court are as follows:

The petitioner, Adam A. Adams, is an individual, presently residing at 231 Elmwynd Drive, Orange, New Jersey. He filed an income tax return for the calendar year in question with the collector of internal revenue for the fifth dis-

trict of New Jersey (App. 32a; Par. 1 of Petition, admitted by Answer).

The Newark Theatre Building Corporation (hereinafter referred to as the Corporation) is a corporation of New Jersey (Petitioner's Exhibit 1). Prior to December 6, 1940, said Corporation had an authorized capital stock of 6,000 shares of common stock, each of the par value of $100.00 (Petitioner's Exhibits 1, 3). Of such authorized par value stock, there were issued and outstanding, at said date and until January 27, 1941, 5,914 shares, of which petitioner was the owner and holder of 5,903 shares (App. 10a, 11a, 30a).

On December 6, 1940, a plan of recapitalization was adopted by the stockholders of the Corporation to reduce the aggregate par value of the authorized capital stock from $600,000.00 to $295,700.00, to be divided into 5,914 shares of stock of no par value (or a stated value of $50 each), and to issue 6%, twenty-year debenture bonds, in the aggregate principal sum of $295,700.00 (Petitioner's Exhibit 2, App. 62a-68a, 11a). Said plan provided, furthermore, for the issuance by the Corporation of one no par value share and one $50.00 debenture bond in exchange for each $100.00 par value share of stock which it had outstanding (Petitioner's Exhibit 2, App. 62a-68a, 11a).

The plan to recapitalize was adopted for several reasons. Among such reasons were the savings in federal income and state franchise taxes to be effected thereby (App. 10a-11a, 26a, 35a). The Corporation accomplished the former by deducting interest payments on the debentures (App. 21a). The Corporation accomplished the latter by a reduction of its outstanding stock, resulting in an annual saving in excess of $400.00 (App. 10a, 30a). To be exact, it

has saved $413.98 each year and will so save in each year of its existence (App. 30a). The legal fees paid with respect to effecting the recapitalization amounted to $759.44 (App. 20a).

Another reason for the recapitalization was the Corporation's desire to refinance its indebtedness (App. 9a). Said indebtedness was in the form of a mortgage on the Corporation's properties, contracted at the time petitioner and his brother were doing business as a partnership (App. 9a, 32a). Both men had become individually and personally liable on the bond (App. 9a, 32a). Said liability continued subsequent to the severance of their incorporated interests and Peter Adams repeatedly demanded he be taken off the bond, he no longer having any interest in the Newark Theatre Building Corporation (App. 10a, 32a). Due to the maturity date of the mortgage, refinancing thereof became necessary and pressing (App. 19a, 33a). Repeated efforts on the part of the Corporation to have the mortgagee relinquish Peter Adams's personal liability failed (App. 10a, 32a), as did many attempts to negotiate a new loan (App. 10a). The Corporation, at the time of the proposed plan, concluded that it would be easier to finance a loan if it issued bonds which it could place as collateral, "rather than the common stock of the company which in itself nobody seemed to want to take as collateral" (App. 10a, 19a, 32a). To the end that the value of its property could be ascertained for purposes of negotiating such a loan (App. 60a), an investigation of its realty on Market Street, Newark, was made between December 15-30, 1940 and an appraisal was submitted as of January 1, 1941 (App. 40a). The appraiser was neither informed as to the reason therefor nor the purpose thereof (App. 40a, 60a).

In addition, the recapitalization was undertaken because Mr. Adams desired to give some bonds to members of his family (App. 21a, 33a).

The foregoing plan of recapitalization was carried out in exact accordance with its terms (App. 12a). Pursuant thereto, on January 27, 1941, petitioner surrendered to the Corporation his 5,903 shares, the shareholders of the other 11 outstanding certificates did likewise, and new certificates and debentures of the type called for by the plan were issued to them (App. 11a, 12a, Petitioner's Exhibits 4, 5, App. 69a, 70a-71a). The Corporation's capital stock account was written down from $591,400.00 to $295,700.00 (App. 18a), the balance was credited to debentures (App. 18a), and its certificate of incorporation was amended, pursuant to the plan of reorganization (Petitioner's Exhibit 6, App. 72a-78a). No entries or changes were made with respect to the surplus account (App. 18a, Petitioner's Exhibits 7, 8, App. 79a-82a). Nor was there any intent on the part of the Corporation to take anything out of surplus or to declare a dividend (App. 19a). And it was found as a fact by the Tax Court that: "The surplus account was not affected" (App. 86a, 98a).

The earnings and profits of the Corporation accumulated since February 28, 1913, and up to December 31, 1940, were $157,225.05, and up to December 31, 1941, were $164,874.47, of which $111,596 had been capitalized by stock dividends declared in prior years. (App. 13a, 27a, Petitioner's Ex. 7, App. 79a-80a). The accumulated earnings and profits of the corporation available for distribution on January 26, 1941, were not less than $164,514.82.

The debentures regularly earned and paid the interest due on them.

2. The facts established at the hearing of the instant cause, but with respect to which the Tax Court neglected and omitted to make findings, relate to petitioner's cost basis of his 5,903 shares and the fair value of the property received by him in exchange therefor. However, as hereinafter indicated, important federal questions of law which were raised before, and not passed upon by, the United States Circuit Court of Appeals for the Third Circuit with respect to subsidiary issues herein involved, turn upon such facts and would appear to make imperative a remand of the case to the Tax Court with instructions to make further findings of fact, if the Circuit Court is not reversed upon the principal issue herein involved.

The testimony at the hearing of the instant cause is clear that petitioner's 5,903 shares were acquired by him at various times prior to the reorganization, at an aggregate adjusted cost to him of $417,944.28 (App. 16a, 17a, 21a, 30a). Said cost basis had its roots in petitioner's initial investment in certain partnership assets (App. 14a, 22a, 27a, 28a) and subsequ[redacted] in successor corporations, all testimony with respect to which was minutely developed at the hearing (App. 14a-25a, inclusive).

The testimony is equally clear that the fair value of the property received in exchange by petitioner for his 5,903 shares of stock was $272,086.69 (App. 44a-58a, inclusive). Accordingly, petitioner realized a loss of $145,857.59 upon the exchange.

3. The case was tried in the Tax Court before Judge Kern, who made findings of fact and rendered an opinion (promulgated on April 26, 1945) in favor of the petitioner.

Subsequently, and pursuant to an order of Judge Murdock, dated May 1, 1945, the case was referred by him to the entire Court for review. Thereupon, the earlier decision was reversed by a divided court, the majority opinion being written by Judge Opper. Said opinion was promulgated on June 29, 1945. Judges Arundell, Smith, Black, Hill and Kern dissented. Two separate dissenting opinions were filed.

On September 6, 1945, petitioner filed with the Clerk of the Tax Court of the United States a petition for review by the United States Circuit Court of Appeals for the Third Circuit of the decision of the Tax Court. Said cause was argued before the Circuit Court of Appeals on February 7, 1946, before Judges Maris, Goodrich and O'Connell. On February 15, 1946, the Circuit Court, on its own motion, ordered the case restored to the argument list for re-argument before the court *en banc*. The case was re-argued on March 5, 1946 before Judges Biggs, Maris, Goodrich, McLaughlin and O'Connell. The opinion of the Circuit Court was filed on April 16, 1946. Judges Maris and Goodrich filed a dissenting opinion.

B.

Jurisdiction.

1. The date of the judgment of the Circuit Court of Appeals for the Third Circuit to be reviewed was April 16, 1946.

2. This petition was filed within three months of April 16, 1946.

3. The jurisdiction of the Court to issue the writ of certiorari herein prayed for is invoked under Judicial Code, Section 240(a), as amended by the Act of February 13, 1925, 43 Stat. 938 (U. S. C. A., Title 28, Section 347).

C.

Questions Presented.

The questions presented are:

1. Was an exchange of $100 par value shares of the Newark Theatre Building Corporation for new no par common stock and debenture bonds of the same corporation, pursuant to a plan of reorganization, an exchange upon which gain or loss is not recognized under Sections 112(b) and 112(g) of the Internal Revenue Code, or was such exchange equivalent to the distribution of a taxable dividend under Section 115(g)?* If the latter, what was the extent of such dividend?

2. In order that a recapitalization come within the statutory provisions providing for non-recognition of gain, must it appear that such recapitalization was adopted and carried out for a business purpose? If so, must such purpose be a corporate purpose as distinguished from a stockholder purpose?

3. Are not the purposes herein set forth business purposes of the corporation as well as of the stockholders?

4. In view of the fact that the corporation's surplus account was not affected in the economic or accounting

* All sections of the Internal Revenue Code herein referred to are set forth in the Addendum, attached hereto.

sense, could the recapitalization herein involved have resulted in a distribution "essentially equivalent to a taxable dividend"?

5. In view of the fact that the exchange herein resulted in a loss to petitioner if gain or loss is to be recognized, could said exchange have resulted in the distribution of a taxable dividend to him?

6. Did petitioner realize any income in the constitutional or statutory sense from the recapitalization?

7. In view of the fact that a loss occurred, did not petitioner actually overpay his tax?

D.

Reasons Relied Upon for Allowance of Writ.

1. The Circuit Court of Appeals for the Third Circuit, in holding that the recapitalization herein involved resulted in a distribution "essentially equivalent to a taxable dividend" in spite of the Tax Court's finding of fact that the corporation's surplus account was not affected, has reached a result in direct conflict with the prevailing authority established by the Circuit Court of Appeals for the First Circuit on the same matter. *Bass v. Commissioner*, 129 F(2d) 300 (C. C. A. 1st, 1942).

2. The Circuit Court of Appeals for the Third Circuit, in holding that a recapitalization within Sections 112(g) (1) (E) and 112(b) (3) of the Internal Revenue Code must have a corporate business purpose, is the first appellate tribunal to inject such a requirement into said sections. Whether said sections of the Internal Revenue Code require a corporate business purpose presents an important question of Federal law which has not been, but should be, settled by this Court.

3. The Circuit Court of Appeals for the Third Circuit, in holding that a recapitalization within Sections 112 (g) (1) (E) and 112 (b) (3) of the Internal Revenue Code must have a corporate business purpose, has decided a Federal question in a way which is an unwarranted extension of authority established by this Court. *Gregory* v. *Helvering*, 293 U. S. 465 (1935).

4. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, failed to pass upon the Federal questions of law heretofore raised by petitioner involving Sections 112 (b) (2), 112 (c) (1) and 112 (e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112 (b) (3), the exchange herein could not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss.

5. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, failed to pass upon the Federal questions of law heretofore raised by petitioner involving Sections 111, 112 (a) and 117 of the Internal Revenue Code. Under these sections, even if recognition of gain or loss upon the exchange was not precluded under Section 112 (b) (3) and even if said exchange was not a loss transaction under Sections 112 (b) (2), 112 (c) (1) and 112 (e), then said exchange was one upon which gain or loss was recognized, subject to treatment as a capital gain or loss, and the petitioner sustained a loss as a result thereof. This, in turn, resulted in an overpayment of tax by petitioner for the taxable year in question.

6. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, has violated the

Sixteenth Amendment to the Constitution of the United States as well as Section 22 of the Internal Revenue Code, which lay down the concept of "income" in the constitutional and statutory sense, respectively, and has decided the Federal question of what is income in direct conflict with decisions of this Court: *Eisner* v. *Macomber*, 252 U. S. 189 (1920); *Strassburger* v. *Commissioner*, 318 U. S. 604 (1943); *Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

WHEREFORE, your petitioner prays that a writ of certiorari issue out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Third Circuit, commanding the said Court to certify and send to this Court for its review and determination on a day certain to be therein designated, a full and complete transcript of the record and of all the proceedings of the said Circuit Court of Appeals, in the said case entitled in that court: Adam A. Adams *vs.* Commissioner of Internal Revenue, No. 9069, October Term, 1945, to the end that this case may be reviewed and determined by this Court as provided for by the statutes of the United States and that the judgment herein of the Circuit Court of Appeals be reversed by this Honorable Court, and for such other and further relief as to this Court may seem proper.

ADAM A. ADAMS.
By SYDNEY A. GUTKIN,
Attorney for and of Counsel with
Petitioner.

Supreme Court of the United States

OCTOBER TERM, 1945.

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

Opinions of the Courts Below.

The original opinion of the Tax Court of the United States in this proceeding was promulgated on April 26, 1945. It is reported at 4 T. C. 1186 and is printed in the Appendix at page 83 a.

The superseding opinion of the Tax Court of the United States in this proceeding was promulgated on June 29, 1945. It is reported at 5 T. C. 351 and is printed in the Appendix at page 95 a.

The opinion of the United States Circuit Court of Appeals for the Third Circuit has not been officially reported at the time of the filing of this brief, but said opinion was

rendered on April 16, 1946 and is found in the Appendix at page 114a.

II.

Jurisdiction.

In the interests of brevity, the jurisdictional facts set out in Title B of the foregoing Petition will not be repeated here.

III.

Statement of the Case.

The basic facts are set forth in the foregoing petition. In the interests of brevity, the statement will not be repeated, although so far as may be necessary, further facts will be discussed in connection with the argument.

IV.

Specification of Errors.

1. The Circuit Court of Appeals for the Third Circuit erred in holding that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend where the Tax Court found as a fact that the corporation's surplus account was not affected.

2. The Circuit Court of Appeals for the Third Circuit erred in holding that a recapitalization within Sections

112(g)(1)(E) and 112(b)(3) of the Internal Revenue Code must have a corporate business purpose.

3. The Circuit Court of Appeals for the Third Circuit erred in failing to hold that the recapitalization herein had a corporate business purpose.

4. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 112(h)(2), 112(c)(1), and 112(e) of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

5. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 111, 112(a) and 117 of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

6. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in holding that the petitioner realized income.

7. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to find that the petitioner sustained a loss.

V.

THE ARGUMENT.

POINT A.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with the prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case.

Under Section 115 (a) of the Internal Revenue Code a dividend is any *distribution* by a corporation to its shareholders, whether in money or property, either out of *accumulated earnings and profits or earnings and profits of the taxable year.* The facts herein clearly indicate there was no *intent on the part of the Corporation to declare a dividend, that no entries or changes were made with respect to the surplus account, that there was no "distribution" of money or other property, and that petitioner's aggregate wealth was in no way increased.* Moreover, *the Tax Court found as a fact that the surplus account was not affected.*

It is a fundamental accounting principle that dividends, if declared and paid, must come from some surplus account,

whether it be earned and available or otherwise. It is a fundamental principle of tax and corporation law that every dividend involves, in the first instance, a segregation out of surplus account of a definite portion of the corporate earnings and profits available for dividends, thereby making such profits unavailable for future distribution at the discretion of the directors. It would be a contradiction in terms to say that there has been a "distribution" out of "earnings or profits" when such earnings and profits have been left intact and available for dividend distributions in the future. Aside from the constancy of the Corporation's surplus account in the accounting sense, there was, in the economic sense, as much available for future dividend distributions subsequent to the exchange as prior thereto. It is submitted that there could not have been any such distribution of earnings and profits as is envisaged by Sections 115 (a) or 115 (g) of the Code.

The foregoing principles have been forcefully enunciated by the Circuit Court of Appeals for the First Circuit in *Bass* v. *Commissioner*, 129 F(2d) 300(1942) in its reversal of the decision of the Board of Tax Appeals in *Edith B. Bass*, 45 B. T. A. 1117 (1941), and there can be no doubt that had the case at bar arisen in the First Circuit, the result herein would have been different from that reached by the Third Circuit.

The Tax Court recognized the precedent set by the First Circuit Court, but chose to ignore appellate authority with a statement that with "the greatest deference, however, we remain of the opinion that the decision of the Board of Tax Appeals in that case was correct, and we feel obliged to adhere to it rather than to follow the reason-

ing of the opinion of reversal". The majority of the Tax Court cited in this connection and relied upon *Doerschuck* v. *United States*, 274 Fed. 739 (D. C. E. D. N. Y., 1921) and *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546 (1918), neither of which is applicable herein. In the *Doerschuck* case, a corporation voted an issue of $738,000.00 of debenture bonds *from its surplus account*, and said bonds came into the hands of plaintiffs in the proportion of their stockholdings. There was no reorganization involved. The Court found that the plaintiffs received an actual payment of profits which the company wished to distribute as earnings to its stockholders. In the *Peabody* case, there was a *declaration of a dividend* by a corporation and the payment of such dividend by cash and stock held by it in a second corporation. Thus, there was a dividend *distribution in specie*. No reorganization was involved. Neither of these cases stands for anything more than the general proposition that a dividend distribution may take the form of property other than money. Obviously, said cases have no bearing on the issue before this Court.

Nor has the conflict of opinion between the Circuit Courts of Appeals for the First and Third Circuits in any way been alleviated or resolved by the decisions of this Court which the Third Circuit cited in support of the collateral proposition that corporate accounting concepts do not control tax incidents, eg. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283 (1945); *Commissioner* v. *Wheeler*, 324 U. S. 542 (1945); *Helvering* v. *Gowran*, 302 U. S. 238 (1937). Petitioner concedes that mere bookkeeping entries should not be conclusive with respect to tax consequences, but submits that none of the cases cited by the Third Circuit

Court of Appeals furnish any precedent for its holding herein that the exchange amounted to a distribution essentially equivalent to a dividend. In the *Bedford* case, the taxpayer, in connection with a recapitalization, exchanged his preferred stock for other preferred stock and common stock of the same corporation, *and cash*. Admittedly, the recapitalization was a tax-free exchange, the sole issue being whether the cash distribution was taxable as a dividend or a capital gain. In the *Gowran* case, a *dividend had been declared* on common stock payable in preferred stock. The question there concerned the taxation as income of the preferred stock dividend and the proceeds received on the sale thereof. In the *Wheeler* case, the issue involved the proper basis to be used to compute, pursuant to Section 112(b)(7) of the Revenue Act of 1938, the amount of "earnings and profits" distributed as liquidating dividends. The question did not concern whether there *was* a distribution, but rather the amount thereof, which, in turn, depended upon whether certain gain included in "earnings and profits" was properly computed by using as the basis of the assets in question the cost to the transferors rather than the higher market value when acquired.

The Third Circuit's citation of *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), in support of the proposition that under Section 115 (b) every distribution is made out of earnings or profits to the extent thereof is likewise considered inappropriate here. Petitioner does not deny the rule as stated but points to its inapplicability in the instant case. Section 115 (b) of the Code attributes a source to distributions *when distributions are made*, and when such is

the case, they are deemed to be made out of earnings or profits to the extent thereof. "Section 115 (b) does not, however, prescribe the criteria for determining when a distribution has taken place, as distinguished from an exchange, which is governed by Section 112", *Bass v. Commissioner, supra*, page 308, nor does it convert "what is not income into income." *Leland v. Commissioner*, 50 F (2d) 523, 525 (C. C. A. 1st, 1931).

It is submitted that there exists a real, basic cleavage between the First and Third Circuit Courts of Appeals with respect to the possibility of having a dividend, in the economic sense, distributed to a stockholder of a corporation, or of having such a distribution which is essentially equivalent to the distribution of a dividend, where surplus, in the economic sense, has not been affected.

To resolve this conflict and to avoid wasteful litigation which is sure to arise in the future with respect to the issue here presented, petitioner emphasizes the need for a definitive pronouncement by this Court and therefore prays that the Writ herein sought be granted.

POINT B.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose to be within Sections 112 (g) (1) (E) and 112 (b) (3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering*, 293 U. S. 465 (1935).

The Circuit Court of Appeals for the Third Circuit is the first appellate tribunal, so far as can be ascertained, to inject into Sections 112(g) (1) (E) and 112(b) (3) the requirement that a recapitalization, to be within the non-recognition provisions, must have a corporate business purpose. *Bazley* v. *Commissioner*, F. (2d) , Dkt. No. 8947, Opinion filed 4/16/46.

There appears to be no legislative or judicial precedent for such requirement. There is nothing in the plain language of the statute which requires a corporate business purpose. There is nothing in the legislative history of the foregoing sections which indicates that the enactors thereof intended that such purpose should be prerequisite to the invocation and operation of the sections. In fact, the whole doctrine is a fiction of the Tax Court, having been brought to light in recapitalization cases for the first time in *Louis Wolfhouse, Jr.*, 3 T. C. 363 (1944).

Inasmuch as the question has been excellently stated and discussed by Judges Maris and Goodrich in their dissenting opinion in the *Bazley* case, which was likewise

adopted by them with respect to the instant case, it is in great measure now quoted:

> "The critical question in this case is, we think, one of law and one upon which this Court has an obligation to exercise its own judgment when the decision of the Tax Court is brought here for review. That question is whether a corporate reorganization, in order to be tax free, must be one conducted for a 'corporate business purpose' of the corporation as distinguished from serving a proper business interest of the shareholders.
>
> "That this question is squarely presented there can be no doubt. * * * We accept the Tax Court's findings of fact. We also, now that we understand we are so to do, accept its conclusion when it applies its facts to a correct rule of law regardless of whether we, in a particular instance, would have reached the same conclusion or not. But if we believe the legal criterion used by the Tax Court is incorrect it is our duty so to say and to send the case back for appropriate proceedings under the application of what we deem the correct criterion.
>
> "We think that the criterion here making a distinction between 'corporate' and 'shareholder' purpose is incorrect. The foundation for it is supposed to be Gregory *v.* Helvering, 293 U. S. 465 (1935). That case involved the formation of a dummy corporation which did no business otherwise than to participate in a transfer which the taxpayer was seeking to effect without tax liability. What we had was a sale masquerading as a reorganization. The court struck through the sham.
>
> "To expand that decision into a rule of law such as is now contended for is to push it beyond anything which we think the court could have had in

mind. Nor do we think the expansion is one which a reasonable growth beyond Gregory *v.* Helvering would call for. We have long since passed the place in our thinking where we view the corporation as 'an artificial being, invisible, intangible and existing only in contemplation of law'. We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders. Shareholders, of course, may have conflicting interests among themselves with regard to the conduct of their common enterprise. They may fight with each other, perhaps, in order to elect A instead of B to the directorship of their company. And, of course, aside from their interest in the common enterprise, called their corporation, they have interests as varied as the hopes and desires of human beings. But when we talk about the interest of shareholders in connection with the business enterprise and have a finding of fact that such and such a thing was done and that it was to the shareholders' business advantage, speaking of them as a group, we do not find substance in a distinction between the business advantages of the shareholders with respect to the corporation or the business advantages of the corporation itself.

Furthermore, this very thing concerned with here, reorganization, is a matter in which shareholders directly participate. The day to day business of the corporation is done by its officers, directors, employees. But a realignment of the interests in the enterprise through reorganization must come, under every corporation law we know of, through vote of the shareholders. In such circumstances it is as a practical matter impossible to separate as to the very transaction involved a 'shareholder's' from a 'corporate' interest.

"We think the distinction attempted coming, as it does, quite a number of years after Gregory *v.* Helvering, is one not established by that decision, the statute, nor the regulations. If reorganization provisions contain too many avenues of escape for taxes which ought to be collected the Congress can close those avenues by appropriate legislation which can be so framed and defined as to leave the way clear to what it deems are business transactions in which no gain or loss should be recognized. We do not think it should be by judicial decision which establishes the exceedingly vague criterion as to whether a given transaction was to the interest of the shareholder as distinguished from the interest of the corporation in which he holds shares of stock.

"The gloss here sought to be placed upon those provisions of Section 112 of the Internal Revenue Code which render nontaxable the exchange of certain securities in connection with corporate reorganizations, can only be justified upon the assumption that all reorganizations which are put through by stockholders solely to promote their own business purposes must necessarily involve the motive of tax avoidance. Only upon this assumption can the principle of Gregory *v.* Helvering be applicable. But this assumption is quite unsound as the facts of the case before us demonstrate. And even clearer cases can readily be brought to mind. Suppose a case in which the common shareholders arrange for the reclassification of a part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control. This would be a perfectly proper business purpose of the stockholders involving not a trace of tax avoidance but it would not benefit the business of the corporation as such. We do not think that there

is any authority for the proposition that such a recapitalization would not be within both the letter and the spirit of Section 112.".

It is submitted that should the doctrine of the corporate business purpose be allowed to continue in its present form, rules of law will be supplanted by rules of men. The Tax Court will virtually go into business, and substitute its subjective judgment, based on hindsight, for objective rules of law, in the determination of what is or is not a corporate business purpose. The effect upon business enterprise in the country will be tragic.

In view of the importance of the question to the bench, the bar, and taxpayers all over the country, and because it has been presented for the first time by an appellate tribunal divided within itself, petitioner prays that the Writ herein sought be granted so that this Court may articulate a definitive rule with respect thereto.

POINT C.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b)(2), 112(c)(1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b)(3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss.

At the initial argument and upon re-argument before the Third Circuit Court as well as in his briefs, petitioner submitted that if it was concluded that the recognition of gain or loss with respect to the exchange herein involved was not precluded by the application of Section 112(b)(3), then, no gain or loss was to be recognized because of the operation of Section 112(b)(2), 112(c)(1) and 112(e) of the Code.

In the instant case, common stock in a corporation was exchanged for common stock and bonds in the same corporation. Were it not for the bonds, said exchange would fall completely within Section 112(b)(2), which provides that no gain or loss shall be recognized upon the exchange of common stock *solely* for common stock in the same corporation. However, where other property—that is, "boot"—is given in addition to stock, Sections 112(c)(1) and 112(e) become important.

Under Section 112(c)(1), if an exchange would be within Section 112(b)(2), precluding recognition of gain or loss, except for the fact that other property is given, then the *gain* to the recipient shall be recognized, but in an amount not in excess of the fair market value of such other property. Inasmuch as Section 112(c) concerns itself exclusively with the case where the fair value of the stock and boot exceed the basis of the stock surrendered in exchange therefor, it is accordingly inapplicable to the exchange herein, *which resulted in a loss.*

It should be noted that the undisputed facts herein show that the cost basis to the petitioner of his shares exceeded the fair value of the assets received by him in exchange therefor, resulting in a loss to him. The Tax Court, however, made no findings of fact with respect to such loss. We fail to perceive why it did not.

Having resulted in a loss, the exchange would be governed by Section 112(e). This section provides that if an exchange would be within Section 112(b) if it were not for the boot, and if the exchange results in a loss, such loss is not to be recognized, even though the transaction involves boot.

It is clear therefore, that even if the Third Circuit Court is correct in its conclusion that the recognition of gain or loss is not precluded by Section 112(b)(3), the application of Sections 112(b)(2) and 112(e) precludes the recognition of loss and compels the very result for which petitioner contends. The Court's failure to consider the problems inherent in the latter sections has greatly prejudiced petitioner's position herein and has resulted in grave in-

justice to him. The inequity of having a distribution taxed to him as a dividend when the transaction resulted in a loss is manifest. Accordingly, petitioner prays for the issuance of the Writ so that this Court may give proper consideration to said sections of the Code.

POINT D.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111, 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941.

At the initial argument and upon re-argument before the Third Circuit Court, as well as in his briefs, petitioner submitted that the exchange of the Corporation's par value stock for new stock and debentures, of necessity, had to fall within one of three spheres: either if was (1) a tax-free reorganization within Sections 112(b)(3) and 112(g)(1)(E), upon which gain or loss is not recognized; or (2) it is a boot transaction upon which there is loss, said loss not being recognized, pursuant to Sections 112(b)(2) and 112(c), as contended under Point C; or (3) it is an exchange upon which gain or loss is recognized, subject to treatment as a capital gain or loss, pursuant to Sections 111, 112(a) and 117 of the Code.

Petitioner argued before the Circuit Court, and now reiterates, that if it is found that the exchange herein constituted an exchange requiring the computation of the realized gain or loss under Section 111; then the extent to which such "realized" gain or loss is to be "recognized" is determined by Section 112 and the extent to which such "recognized" gain or loss is to be taxed is determined by Section 117.

If, therefore, the recapitalization herein falls within the third category enumerated above, petitioner submits that he sustained a loss therefrom in the amount of $145,857.59, which is deductible as a long-term capital loss. Accordingly, petitioner overpaid his tax in 1941 by approximately $20,000.00.

It is not deemed necessary to repeat at length what appears in the Record and with respect to which the Tax Court made no findings of fact. With respect to the cost basis of petitioner's stock, this has been shown to be $417,944.28. The total fair value of the properties received by petitioner upon the exchange herein, appraised from a reproduction and replacement standpoint, was in the amount of $469,837.00. The total fair value of said properties appraised on the basis of capitalization of gross rental, was in the amount of $515,284.00. The petitioner has deemed it fair to average the valuations for the properties by dividing the total thereof, $985,121.00, by two, thereby deriving the quotient of $492,560.00. This last figure represents the fair value of the two parcels of real estate as of the time of the recapitalization.

The other assets of the Corporation, as per its Balance Sheet as at December 31, 1940, were in the amount of $84,923.49. The total assets were therefore in the amount of $577,433.49.

From said total assets are to be deducted mortgages payable on said parcels of realty in the amount of $291,250.00, in addition to other liabilities in the amount of $14,146.80 or a total of $305,396.80.

The difference between the total assets and total liabilities represents the net value of the Corporation's assets on recapitalization. This figure is $272,086.69.

Since the cost basis of petitioner's stock has been established at $417,944.28, and the fair value of the property received in exchange therefor has been shown to be $272,086.69, the loss to petitioner is the differential, or $145,857.59.

The equity, accuracy and inevitability of this result can be more fully appreciated after reference to Section 115(c) of the Code, which expressly provides that the complete liquidation of a corporation shall be regarded, as to stockholders, as an *exchange* of their stock for the assets of the corporation, and that gain or loss represented by the difference between the value of the assets received and the basis of their stock upon such exchange is to be determined under Section 111, recognized only to the extent provided in Section 112, and taxed at the capital gain rates provided by Section 117.

Petitioner, as the dominant stockholder, could have liquidated the company, thereby securing all its assets, and could have sustained and deducted a loss (and escaped

all tax) on the transaction by exchanging assets of a greater cost than the value attributable to the assets received. He could then have conveyed the assets to a new corporation in exchange for precisely the stock and debentures which he received in the instant recapitalization, and would then have held stock and bonds on the basis of their combined value. He would have been liable for no further tax on their sale at such value or their redemption.

As it is, the petitioner has done no more than to postpone the recognition of a loss until the actual sale or exchange of the bonds.

However, should this Court find that the exchange was one upon which gain or loss is recognized, petitioner accordingly submits that the instant cause should be remanded to the Tax Court for further findings with respect to the loss in the amount of $145,857.59, and for a determination regarding petitioner's overpayment of tax.

The failure of the Third Circuit Court to consider the problems inherent in Sections 111, 112(a) and 117 has greatly prejudiced petitioner's position herein, and petitioner accordingly prays for the issuance of the Writ so that this Court may give the proper consideration thereto.

POINT E.

The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court.

The Sixteenth Amendment to the Constitution of the United States invests Congress with the power to lay and collect taxes on "incomes", from whatever source derived, without apportionment among the several States and without regard to any census or enumeration. Section 22 of the Internal Revenue Code, and the applicable regulations, define income to include all gains derived from capital, from labor, or from a combination of both. Both the Constitution and the statute require that there must be a realization of income, before tax incidents with respect thereto may ensue.

There have been suggestions in some cases that bonds issued in connection with a recapitalization, allegedly without business purpose, are not to be treated as bonds but are to be treated in the same manner as the stock given up in exchange therefor. *Commissioner* v. *Kelly Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944), rev'd. on another ground, 66 S. Ct. 299 (1946). If this is so, there can be no realization of income herein in either the statutory or constitutional sense if the Commissioner's contention is correct that no corporate business purpose was served by the recapitalization in question.

If what was issued by the Corporation was stock and not bonds, then nothing more was accomplished than a proliferation of capital, sans taxable consequences. *Eisner* v. *Macomber*, 252 U. S. 189 (1920); *Strassburger* v. *Commissioner*, 318 U. S. 604 (1943); *Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

Accordingly, the bonds do not constitute taxable income and the Third Circuit Court's holding to the contrary is in error.

In addition, it is submitted that since there was a loss in fact incurred upon the transactions, it would be unconstitutional as well as unconscionable to tax petitioner on such loss.

Conclusion.

For the reasons stated in the petition and in this brief, it is respectfully submitted that the application for a Writ of Certiorari be granted.

Respectfully submitted:

SYDNEY A. GUTKIN,
Attorney For and Of Counsel
with Petitioner.

David Beck,
On The Brief.

ADDENDUM.

Constitution and Statute Involved.

CONSTITUTION OF THE UNITED STATES:

Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

INTERNAL REVENUE CODE:

SECTION 22—Gross Income—

(a) General Definition—"Gross income" includes, gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SECTION 111—Determination of Amount of, and Recognition of, Gain or Loss—

(a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * * and the loss shall be the excess of the adjusted basis * * * over the amount realized.

(c) Recognition of Gain or Loss—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

SECTION 112—Recognition of Gain or Loss—

(a) General Rule—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

(2) Stock for stock of same corporation—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) Stock for stock on reorganization—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(c) Gain from Exchanges not Solely in Kind—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by

such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from Exchanges Not Solely in Kind—If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(g) Definition of Reorganization—As used in this section (other than subsection (b) (10) and subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means * * *

(E) a recapitalization * * *.

SECTION 115—Distributions by Corporations—

(a) Definition of Dividend—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) Source of Distributions—For the purposes of this chapter, every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

(c) Distributions in Liquidation—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

(g) Redemption of Stock—If a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

SECTION 117—Capital Gains and Losses—

(b) Percentage Taken Into Account—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

* * * 50 per centum if the capital asset has been held for more than 6 months. * * *

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 209.

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF ON BEHALF OF PETITIONER.

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INDEX.

	PAGE
OPINIONS OF THE COURTS BELOW	1
JURISDICTION	1
STATEMENT OF THE CASE	2
SPECIFICATION OF ASSIGNED ERRORS INTENDED TO BE URGED	6
SUMMARY OF THE ARGUMENT	7
THE ARGUMENT	10
POINT I.—The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with the prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case	10
POINT II.—The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b)(2), 112(c)(1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b)(3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss. The presence of loss distinguishes the instant cause from *Bazley* v. *Commissioner*, 155 F. (2d) 237 (C. C. A. 3rd, 1946)	15

PAGE

POINT III.—The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose (as distinguished from a shareholder purpose) to be within Sections 112(g)(1) (E) and 112(b)(3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering*, 293 U. S. 465 (1935) 18

A. The exchange herein involved falls within the exact tenor of Section 112(b)(3). Where a statute is clear and unambiguous on its face, resort to extraneous materials for the purpose of interpreting it is improper 19

B. The legislative history of the reorganization sections herein involved and pertinent decisions clearly show that a corporate business purpose as distinguished from a shareholder purpose is not required 22

C. The instant plan of reorganization was adopted and effectuated for legitimate business purposes, including corporate and shareholder purposes. The Tax Court found such purposes to be present herein 34

POINT IV.—There is no basis for the holding of the Third Circuit Court, affirming the decision of the Tax Court, that the reorganization herein gave rise to a distribution essentially equivalent to the distribution of a taxable dividend under Section 115(g) of the Internal Revenue Code 39

A. The legislative history of Sections 112(b)(3) and 115(g) furnishes proof that the instant transaction is not governed by Section 115(g) 40

PAGE

B. The law and the applicable regulations demonstrate that the instant transaction cannot be governed by Section 115(a) 44

C. Judicial precedents with respect to Sections 112(b)(3) and 115(g) illustrate the inapplicability of Section 115(g) to the instant transaction 45

D. Section 115(g) is essentially a liquidation provision, thereby being inapplicable herein 47

E. The application of Section 115(g) to the instant transaction distorts the facts herein as well as the intention of the parties 47

POINT V.—The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111, 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941 49

POINT VI.—The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court 52

CONCLUSION 53

APPENDIX 54

CASES CITED.

	PAGE
Adler, Leopold, 30 B. T. A. 897 (1934), aff'd 77 F. (2d) 733 (C. C. A. 5th, 1935)	43
Ahles Realty Corp. v. *Commissioner*, 71 F. (2d) 150 (C. C. A. 2nd, 1934), cert. den. 293 U. S. 611, 55 S. Ct. 141 (1934)	20
Annis Furs, Inc., 2 T. C. 1096 (1943)	20, 21, 35, 36, 46
Bass, Edith B., 45 B. T. A. 1117 (1941)	11
Bass v. *Commissioner*, 129 F. (2d) 300 (C. C. A. 1st, 1942)	7, 11, 14, 20, 21
Bazley v. *Commissioner*, 155 F. (2d) 237 (C. C. A. 3rd, 1946)	7, 10, 16, 19, 30
Brown, Charles R., 7 T. C. No. 86 (Docket No. 9146, September 10, 1946)	21
Chisholm v. *Commissioner*, 79 F. (2d) 14 (C. C. A. 2nd, 1935), cert. den. 296 U. S. 641, 56 S. Ct. 174 (1935)	24, 25
Commissioner v. *Capento Securities Corporation*, 140 F. (2d) 382 (C. C. A. 1st, 1944), aff'g 47 B. T. A. 691 (1942)	20, 21
Commissioner v. *Court Holding Co.*, 324 U. S. 331, 65 S. Ct. 707 (1945)	8, 26
Commissioner v. *Day & Zimmerman*, 151 F. (2d) 517 (C. C. A. 3rd, 1945)	35
Commissioner v. *Estate of Bedford*, 325 U. S. 283, 65 S. Ct. 1157 (1945)	8, 13, 47
Commissioner v. *Gilmore's Estate*, 130 F. (2d) 791 C. C. A. 3rd, (1942)	26
Commissioner v. *Kelley Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944)	52
Commissioner v. *Kolb*, 100 F. (2d) 920 (C. C. A. 9th, 1938)	20
Commissioner v. *Neustadt's Trust*, 131 F. (2d) 528 (C. C. A. 2nd, 1942)	20
Commissioner v. *Wheeler*, 324 U. S. 542, 65 S. Ct. 799 (1945)	13

PAGE

Dobson v. *Commissioner*, 320 U. S. 489, 64 S. Ct. 239 (1943) 9, 34, 53

Docherty, Edgar M., 47 B. T. A. 462 (1942) 20, 21, 30

Doerschuck v. *United States*, 274 Fed. 739 (D. C. E. D. N. Y., 1921) 12

Eisner v. *Macomber*, 252 U. S. 189, 40 S. Ct. 189 (1920) 9, 11, 42, 44, 52

Electrical Securities Corp. v. *Commissioner*, 92 F. (2d) 593 (C. C. A. 2nd, 1937) 26

Fischer, Jacob, 46 B. T. A. 999 (1942) 21, 46

Gregory v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266 (1935) 8, 18, 22, 24, 25, 26, 27, 28, 29, 33

Griffiths v. *Commissioner*, 308 U. S. 355, 60 St. Ct. 277 (1939) 26

Helvering v. *Gowran*, 302 U. S. 238, 58 S. Ct. 154 (1937) 13

Helvering v. *Griffiths*, 318 U. S. 371, 63 S. Ct. 636 (1943) 9, 14, 52

Helvering v. *Minnesota Tea Co.*, 296 U. S. 378, 56 S. Ct. 269 (1935) 26

Helvering v. *Minnesota Tea Co.*, 89 F. (2d) 711 (C. C. A. 8th, 1937) aff'd 302 U. S. 609, 58 S. Ct. 393 (1938) 20

Helvering v. *Southwest Consolidated Corporation*, 315 U. S. 194, 62 S. Ct. 546 (1942) 20

Hill, Annie Watts, 27 B. T. A. 73 (1932), aff'd 66 F. (2d) 45 (C. C. A. 4th, 1933) 43

Johnston, J. D., Jr., 3 T. C. 799 (1944) 26

Kelley Co. v. *Commissioner*, 326 U. S. 521, 66 S. Ct. 299 (1946) 8, 27

Leland v. *Commissioner*, 50 F. (2d) 523 (C. C. A. 1st, 1931) 14

LeTulle v. *Scofield*, 308 U. S. 415, 60 S. Ct. 313 (1940) 21

PAGE

Lusthaus v. *Commissioner*, 327 U. S. 293, 66 S. Ct. 539 (1946) 8, 26

McCord, H. Y., 31 B. T. A. 342 (1934) 45
Meurer Steel Barrel Co. v. *Commissioner*, 144 F. (2d) 282 (C. C. A. 3rd, 1944) 35
Moyer, W. W., 35 B. T. A. 1155 (1937) 26
Munroe, C. A., 39 B. T. A. 685 (1939) 35

National Investors Corp. v. *Hoey*, 144 F. (2d) 466 (C. C. A. 2nd, 1944) 26

Peabody v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546 (1918) 12

Scherer, Robert P., 3 T. C. 776 (1944) 26
Schoo, Clarence J., 47 B. T. A. 459 (1942), Commissioner's Appeal dismissed, (C. C. A. 1st, 1943) 20, 21, 35
Shenandoa Rayon Corporation, 42 B. T. A. 1287 (1940), aff'd. 122 F. (2d) 268 (C. C. A. 2nd, 1941) 46
Smith, M. W., Jr., 3 T. C. 894 (1944) 26
South Atlantic Steamship Line, 42 B. T. A. 704 (1940) 46
Starr v. *Commissioner*, 82 F. (2d) 964 (C. C. A. 4th, 1936), cert. den. 298 U. S. 680, 56 S. Ct. 948 (1936) 20
Strassburger v. *Commissioner*, 318 U. S. 604, 63 S. Ct. 791 (1943) 9, 52

Tower v. *Commissioner*, 327 U. S. 280, 66 S. Ct. 532 (1946) 8, 26, 35

Wellhouse, Louis, Jr., 3 T. C. 363 (1944) 19, 45

Zukaitis, Felix, 3 T. C. 814 (1944) 26

CONSTITUTION, STATUTES AND REGULATIONS.

Constitution of the United States:
Sixteenth Amendment 9, 54

PAGE

Revenue Acts of 1918, 1921:
Section 201 42
Section 202 ..... 40, 41

Revenue Acts of 1924, 1926:
Section 201 ..... 42, 43
Section 203 40

Revenue Act of 1928:
Section 112(g) 23
Section 112(i) 23

Internal Revenue Code:
Section 22 ..... 9, 52, 54
Section 111 ..... 7, 9, 49, 54
Section 112(a) 7, 9, 49, 55
Section 112(b)(2) 6, 7, 9, 15, 16, 17, 18, 49, 55
Section 112(b)(3) 6, 7, 8, 9, 15, 17, 18, 19, 21 22, 23, 33, 37, 40, 45, 46, 49, 55
Section 112(c)(1) 6, 7, 15, 16, 17, 55
Section 112(e) 6, 7, 9, 15, 16, 17, 18, 49, 56
Section 112(g) 6, 8, 9, 18, 19, 22, 23, 45, 46, 56
Section 115(a) 8, 10, 11, 28, 44, 56
Section 115(b) 14, 56
Section 115(c) 44, 51, 57
Section 115(g) 8, 11, 39, 40, 41, 43, 45, 46, 47, 49, 57
Section 117 ..... 7, 9, 49, 57

Judicial Code of United States, 43 Stat. 938, Sec. 240(a) (U. S. C. A., Title 28, Sec. 347) 2

PAGE

Revised Statutes of New Jersey (1937):

Title 14, Chapter 8, Section 19 ..... 14, 57

Title 14, Chapter 11, Section 1 ..... 18, 58

Title 14, Chapter 11, Section 2 ..... 18, 58

Regulations 103:

Section 19:115-1 44

COMMITTEE REPORTS

Senate Finance Report, Revenue Bill of 1918, 1939-1 C. B. (2) 117 40

Senate Finance Report, Revenue Bill of 1921, 1939-1 C. B. (2) 181 ..... 41, 43

Ways & Means Report, Revenue Bill of 1921, 1939-1 C. B. (2) 168 41

Senate Finance Report, Revenue Bill of 1924, 1939-1 C. B. (2) 266 ..... 41, 43

Ways & Means Report, Revenue Bill of 1924, 1939-1 C. B. (2) 241 ..... 41, 43

Ways & Means Report, Revenue Bill of 1934, 1939-1 C. B. (2) 554 22

ARTICLES

Sydney A. Gutkin and David Beck, "Stock Redemptions as Taxable Events Under Section 115(g): The Impressionistic Test", Journal of Accountancy, October, 1945 46

Supreme Court of the United States

OCTOBER TERM, 1946.

No. 209

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF ON BEHALF OF PETITIONER.

Opinions of the Courts Below.

The original opinion of the Tax Court of the United States in this proceeding was promulgated on April 26, 1945. It is reported at 4 T. C. 1186 and is printed in the Record at page 83 a.

The superseding opinion of the Tax Court of the United States in this proceeding was promulgated on June 29, 1945. It is reported at 5 T. C. 351 and is printed in the Record at page 95 a.

The opinion of the United States Circuit Court of Appeals for the Third Circuit was promulgated on April 16, 1946. It is reported at 155 F. (2d) 246 (C. C. A. 3rd, 1946) and is printed in the Record at page 114 a.

Jurisdiction.

1. The date of the judgment of the Circuit Court of Appeals for the Third Circuit to be reviewed was April 16, 1946.

2. Petition for Writ of Certiorari was filed on June 18, 1946.

3. The jurisdiction of the Court to issue the writ of certiorari was invoked under Judicial Code, Section 240(a), as amended by the Act of February 13, 1925, 43 Stat. 938 (U. S. C. A., Title 28, Section 347).

4. The Order of this Court allowing certiorari was filed on October 14, 1946.

Statement of the Case.

1. The facts as found by the Tax Court are as follows:

The petitioner, Adam A. Adams, is an individual, presently residing at 231 Elmwynd Drive, Orange, New Jersey. He filed an income tax return for the calendar year in question with the collector of internal revenue for the fifth district of New Jersey (R. 32a, 96a; Par. 1 of Petition, admitted by Answer).

The Newark Theatre Building Corporation (hereinafter referred to as the Corporation) is a corporation of New Jersey (Petitioner's Exhibit 1, R. 8a, 96a). Prior to December 6, 1940, said Corporation had an authorized capital stock of 6,000 shares of common stock, each of the par value of $100.00 (Petitioner's Exhibits 1, 3, R. 8a, 11a). Of such authorized par value stock, there were issued and outstanding, at said date and until January 27, 1941, 5,914 shares, of which petitioner was the owner and holder of 5,903 shares (R. 10a, 11a, 30a, 96a).

On December 6, 1940, a plan of recapitalization was adopted by the stockholders of the Corporation to reduce the aggregate par value of the authorized capital stock from $600,000.00 to $295,700.00, to be divided into 5,914 shares of stock of no par value (but of a stated value of $50 each),

and to issue 6%, twenty-year debenture bonds, in the aggregate principal sum of $295,700.00 (Petitioner's Exhibit 2, R. 62a-68a, 9a, 11a, 96a-97a). Said plan provided, furthermore, for the issuance by the Corporation of one no par value share and one $50.00 debenture bond in exchange for each $100.00 par value share of stock which it had outstanding (Petitioner's Exhibit 2, R. 62a-68a, 9a, 11a, 97a).

The plan to recapitalize was adopted for several reasons. Among such reasons were the savings in federal income and state franchise taxes to be effected thereby (R. 10a-11a, 20a, 35a, 97a). The Corporation accomplished the former by deducting interest payments on the debentures (R. 21a, 97a). The Corporation accomplished the latter by a reduction of its outstanding stock, resulting in an annual saving in excess of $400.00 (R. 10a, 30a, 98a). To be exact, it has saved $413.98 each year and will so save in each year of its existence (R. 30a). The legal fees paid with respect to effecting the recapitalization amounted to $759.44 (R. 20a).

In addition, the recapitalization was undertaken because Mr. Adams desired to give some bonds to members of his family without surrendering any of his stock control over the company (R. 21a, 33a, 102a-103a).

The foregoing plan of recapitalization was carried out in exact accordance with its terms (R. 12a, 98a). Pursuant thereto, on January 27, 1941, petitioner surrendered to the Corporation his 5,903 shares, the shareholders of the other 11 outstanding certificates did likewise, and in exchange therefor new certificates and debentures of the type called for by the plan were issued to them (R. 11a, 12a, 98a, Petitioner's Exhibits 4, 5, R. 69a, 70a-71a). The Corporation's capital stock account was written down from $591,400.00 to $295,700.00 (R. 18a, 98a), the balance was credited to debentures (R. 18a, 98a), and its certificate of incorporation was amended, pursuant to the plan of reorganization (Peti-

tioner's Exhibit 6, R. 17a, 72a-78a). No entries or changes were made with respect to the surplus account (R. 18a, 98a, Petitioner's Exhibits 7, 8, R. 79a-82a). Nor was there any intent on the part of the Corporation to take anything out of surplus or to declare a dividend (R. 19a). And it was found as a fact by the Tax Court that: "The surplus account was not affected" (R. 86a, 98a).

The earnings and profits of the Corporation accumulated since February 28, 1913, and up to December 31, 1940, were $157,225.05, and up to December 31, 1941, were $164,874.47, of which $111,596 had been capitalized by stock dividends declared in prior years (R. 13a, 27a, 98a, Petitioner's Exhibit 7, R. 18a, 79a-80a). The accumulated earnings and profits of the corporation available for distribution on January 26, 1941, were not less than $164,514.82 (R. 101a).

The debentures regularly earned and paid the interest due on them (R. 101a).

2. The facts established at the hearing of the instant cause, but with respect to which the Tax Court neglected and omitted to make findings, relate to petitioner's cost basis of his 5,903 shares and the fair value of the property received by him in exchange therefor. However, as hereinafter indicated, important federal questions of law which were raised before, and not passed upon by, the United States Circuit Court of Appeals for the Third Circuit with respect to other issues herein involved, turn upon such facts and would appear to make imperative a remand of the case to the Tax Court with instructions to make further findings of fact, if the Circuit Court is not reversed upon any issue herein involved.

The testimony at the hearing of the instant cause is clear that petitioner's 5,903 shares were acquired by him

at various times prior to the reorganization, at an aggregate adjusted cost to him of $417,944.28 (R. 16a, 17a, 21a, 30a). Said cost basis had its roots in petitioner's initial investment in certain partnership assets (R. 14a, 22a, 27a, 28a) and subsequently in successor corporations, all testimony with respect to which was minutely developed at the hearing (R. 14a-25a, inclusive).

The testimony is equally clear that the fair value of the property received in exchange by petitioner for his 5,903 shares of stock was $272,086.69 (R. 44a-58a, inclusive). Accordingly, petitioner realized a loss of $145,857.59 upon the exchange.

3. The case was tried in the Tax Court before Judge Kern, who made findings of fact and rendered an opinion (promulgated on April 26, 1945) in favor of the petitioner.

Subsequently, and pursuant to an order of Judge Murdock, dated May 1, 1945, the case was referred by him to the entire Court for review. Thereupon, the earlier decision was reversed by a divided court, the majority opinion being written by Judge Opper. Said opinion was promulgated on June 29, 1945. Judges Arundell, Smith, Black, Hill and Kern dissented. Two separate dissenting opinions were filed.

On September 6, 1945, petitioner filed with the Clerk of the Tax Court of the United States a petition for review by the United States Circuit Court of Appeals for the Third Circuit of the decision of the Tax Court. Said cause was argued before the Circuit Court of Appeals on February 7, 1946, before Judges Maris, Goodrich and O'Connell. On February [illegible]946, the Circuit Court, on its own motion, ordered the case restored to the argument list for re-argument before the court *en banc*. The case was re-argued on March 5, 1946 before Judges Biggs, Maris,

Goodrich, McLaughlin and O'Connell. The opinion of the Circuit Court was filed on April 16, 1946. Judges Maris and Goodrich filed a dissenting opinion.

Specification of Assigned Errors Intended to be Urged.

1. The Circuit Court of Appeals for the Third Circuit erred in holding that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend where the Tax Court found as a fact that the corporation's surplus account was not affected.

2. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 112(b)(2)*, 112(c)(1), and 112(e) of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

3. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to find that the petitioner sustained a loss.

4. The Circuit Court of Appeals for the Third Circuit erred in holding that a recapitalization within Sections 112(g)(1)(E) and 112(b)(3) of the Internal Revenue Code must have a corporate business purpose.

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* All sections of the Internal Revenue Code herein referred to are set forth in the Appendix, attached hereto.

5. The Circuit Court of Appeals for the Third Circuit erred in failing to hold that the recapitalization herein had a corporate business purpose.

6. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 111, 112(a) and 117 of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

7. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in holding that the petitioner realized income.

Summary of the Argument.

POINT I. Inasmuch as the Tax Court found as a fact that the surplus account of the corporation was not affected by the recapitalization herein, the instant case is controlled by precedent laid down in *Bass* v. *Commissioner*, 129 F. (2d) 300 (C. C. A. 1st, 1942), that there can be no distribution of a taxable dividend under such circumstances. The constancy of the corporation's surplus account distinguishes the case at bar from *Bazley* v. *Commissioner*, 155 F. (2d) 237 (C. C. A. 3rd, 1946), cert. granted October 14, 1946.

POINT II. If gain or loss is not precluded by the application of Section 112(b)(3), which is denied, then under Sections 112(b)(2), 112(c)(1) and 112(e), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss. The presence of loss distinguishes the case at bar from *Bazley* v. *Commissioner*, *supra*. Should this Court not reverse the

Third Circuit upon any other issue herein involved, it is submitted that this Court should remand the cause to the Tax Court for further findings with respect to such loss.

POINT III. There is no requirement in the statute, the legislative history, or case law that a corporate business purpose as distinguished from a shareholder purpose is necessary to bring a recapitalization exchange within Sections 112(g)(1)(E) and 112(b)(3). The holding of the Third Circuit Court requiring a corporate business purpose is interstitial legislation, and is an unwarranted extension of *Gregory* v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266 (1935). This is evidenced by this Court's interpretation of the *Gregory* rule in *Tower* v. *Commissioner*, 327 U. S. 280, 66 S. Ct. 532 (1946); *Lusthaus* v. *Commissioner*, 327 U. S. 293, 66 S. Ct. 539 (1946); *Commissioner* v. *Court Holding Company*, 324 U. S. 331, 65 S. Ct. 707 (1945); *John Kelley Company* v. *Commissioner*, 326 U. S. 521, 66 S. Ct. 299 (1946). Even if a corporate business purpose is required, the Tax Court has made findings of fact which demonstrate that such purpose exists herein.

POINT IV. There is no basis in the statute, legislative history, case law, or facts to substantiate the holding of the Third Circuit Court that the recapitalization herein gave rise to the distribution of a taxable dividend under Section 115(g). Nowhere does it appear that Congress intended Section 115(g) to apply to recapitalizations or to situations where a corporation's own bonds were issued in connection therewith. Nor can such recapitalization be governed by Section 115(a). The holding of the Third Circuit Court takes a Section 112 transaction out of the compass of that section and forces it into the mold of Section 115, in direct violation of language of this Court. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283, 65 S. Ct. 1157 (1945).

POINT V. If the instant exchange is not a tax-free reorganization within Sections 112(b)(3) and 112(g)(1)(E), upon which gain or loss is not recognized, or if it is not considered a boot transaction upon which there is loss, said loss not being recognized pursuant to Sections 112(b)(2) and 112(e), then such exchange is one upon which gain or loss is recognized, subject to treatment as a capital gain or loss, pursuant to Sections 111, 112(a) and 117. Accordingly, petitioner sustained a loss, which is deductible as a long-term loss, and is entitled to a refund in tax approximating $20,000.00.

POINT VI. The holding of the Third Circuit Court, to the effect that petitioner *realized* any income, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court. *Eisner* v. *Macomber*, 252 U. S. 189, 40 S. Ct. 189 (1920); *Strassburger* v. *Commissioner*, 318 U. S. 604, 63 S. Ct. 791 (1943); *Helvering* v. *Griffiths*, 318 U. S. 371, 63 S. Ct. 636 (1943). There is no principle of law which compels the Tax Court to find taxable income in a transaction where as a matter of fact there is no economic gain. *Dobson* v. *Commissioner*, 320 U. S. 489, 64 S. Ct. 239 (1943).

THE ARGUMENT.

POINT I.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with the prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case.

Under Section 115 (a) of the Internal Revenue Code a dividend is any *distribution* by a corporation to its shareholders, whether in money or property, either out of *accumulated earnings and profits or earnings and profits of the taxable year.* The facts herein clearly indicate there was no *intent on the part of the Corporation to declare a dividend; that no entries or changes were made with respect to the surplus account, that there was no "distribution" of money or other property, and that petitioner's aggregate wealth was in no way increased.* Moreover, *the Tax Court found as a fact that the surplus account was not affected,* and this clearly distinguishes the instant cause from *Bazley v. Commissioner, supra.*

It is a fundamental accounting principle that dividends, if declared and paid, must come from some surplus account, whether it be earned and available or otherwise. It is a fundamental principle of tax and corporation law that every dividend involves, in the first instance, a segregation

out of surplus account of a definite portion of the corporate earnings and profits available for dividends, thereby making such profits unavailable for future distribution at the discretion of the directors. It would be a contradiction in terms to say that there has been a "distribution" out of "earnings or profits" when such earnings and profits have been left intact and available for dividend distributions in the future. Aside from the constancy of the Corporation's surplus account in the accounting sense, there was, in the economic sense, as much available for future dividend distributions subsequent to the exchange as prior thereto. It is submitted that there could not have been any such distribution of earnings and profits as is envisaged by Sections 115 (a) or 115 (g) of the Code.

The foregoing principles have been forcefully enunciated by the Circuit Court of Appeals for the First Circuit in *Bass* v. *Commissioner, supra*, in its reversal of the decision of the Board of Tax Appeals in *Edith B. Bass*, 45 B. T. A. 1117 (1941), and there can be no doubt that had the case at bar arisen in the First Circuit, the result herein would have been different from that reached by the Third Circuit.

The First Circuit Court, relying upon *Eisner* v. *Macomber, supra*, stated that even a stock dividend required a segregation out of surplus account of a definite portion of corporate earnings or profits theretofore available for dividends, the freezing of such segregated earnings as part of the permanent capital resources of the corporation by the device of capitalizing the same, and the issuance to the stockholders of additional shares of stock representing the profits so capitalized. The court then stated that if "profits are capitalized by means of a stock dividend such profits are no longer available for the declara-

tion of a dividend at the discretion of the directors but become part of the permanent capital of the corporation, thereby tending to enhance the corporation's credit. If profits are not capitalized they may be distributed as dividends some time in the future; and it would be a contradiction in terms to say there has been in any sense a 'distribution' out of 'earnings or profits' when such earnings have been expressly held intact in the surplus account for possible future distribution" (p. 305).

The Tax Court recognized the precedent set by the First Circuit Court, but chose to ignore appellate authority with a statement that with "the greatest deference, however, we remain of the opinion that the decision of the Board of Tax Appeals in that case was correct, and we feel obliged to adhere to it rather than to follow the reasoning of the opinion of reversal". The majority of the Tax Court cited in this connection and relied upon, *Doerschuck* v. *United States,* 274 Fed. 739 (D. C. E. D. N. Y., 1921) and *Peabody* v. *Eisner,* 247 U. S. 347, 38 S. Ct. 546 (1918), neither of which is applicable herein. In the *Doerschuck* case, a corporation voted an issue of $738,000.00 of debenture bonds *from its surplus account,* and said bonds came into the hands of plaintiffs in the proportion of their stockholdings. There was no reorganization involved. The Court found that the plaintiffs received an actual payment of profits which the company wished to distribute as earnings to its stockholders. In the *Peabody* case, there was a *declaration of a dividend* by a corporation and the payment of such dividend by cash and stock held by it in a second corporation. Thus, there was a dividend *distribution in specie.* No reorganization was involved. Neither of these cases stands for anything more than the general proposition that a dividend distribution may take the form

of property other than money. Obviously, said cases have no bearing on the issue before this Court.

Nor has the conflict of opinion between the Circuit Courts of Appeals for the First and Third Circuits in any way been alleviated or resolved by the decisions of this Court which the Third Circuit cited in support of the collateral proposition that corporate accounting concepts do not control tax incidents, e. g. *Commissioner* v. *Estate of Bedford*, *supra*; *Commissioner* v. *Wheeler*, 324 U. S. 542, 65 S. Ct. 799 (1945); *Helvering* v. *Gowran*, 302 U. S. 238, 58 S. Ct. 154 (1937). Petitioner concedes that mere bookkeeping entries should not be conclusive with respect to tax consequences, but submits that none of the cases cited by the Third Circuit Court of Appeals furnish any precedent for its holding herein that the exchange amounted to a distribution essentially equivalent to a dividend. In the *Bedford* case, the taxpayer, in connection with a recapitalization, exchanged his preferred stock for other preferred stock and common stock of the same corporation, *and cash*. Admittedly, the recapitalization was a tax-free exchange, the sole issue being whether the cash distribution was taxable as a dividend or a capital gain. In the *Gowran* case, a *dividend had been declared* on common stock, payable in preferred stock. The question there concerned the taxation as income of the preferred stock dividend and the proceeds received on the sale thereof. In the *Wheeler* case, the issue involved the proper basis to be used to compute, pursuant to Section 112(b)(7) of the Revenue Act of 1938, the amount of "earnings and profits" distributed as liquidating dividends. The question did not concern whether there *was* a distribution, but rather the amount thereof, which, in turn, depended upon whether certain gain included in "earnings and profits" was properly computed by using as the basis of the

assets in question the cost to the transferors rather than the higher market value when acquired.

The Third Circuit's citation of *Helvering* v. *Griffiths, supra,* in support of the proposition that under Section 115(b) every distribution is made out of earnings or profits to the extent thereof is likewise considered inappropriate here. Petitioner does not deny the rule as stated but points to its inapplicability in the instant case. Section 115(b) of the Code attributes a source to distributions *when distributions are made,* and when such is the case, they are deemed to be made out of earnings or profits to the extent thereof. "Section 115(b) does not, however, prescribe the criteria for determining when a distribution has taken place, as distinguished from an exchange, which is governed by Section 112", *Bass* v. *Commissioner, supra,* page 308, nor does it convert "what is not income into income." *Leland* v. *Commissioner,* 50 F. (2d) 523, 525 (C. C. A. 1st, 1931).

It is submitted that there exists a real, basic cleavage between the First and Third Circuit Courts of Appeals with respect to the possibility of having a dividend, in the economic sense, distributed to a stockholder of a corporation, or of having such a distribution which is essentially equivalent to the distribution of a dividend, where surplus, in the economic sense, has not been segregated for such purpose. See Revised Statutes of New Jersey (1937) 14:8-19.

It is further submitted that the view of the First Circuit Court is buttressed by the weight of logic and reason, and that this Court should find in accordance with that view.

POINT II.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b)(2), 112(c)(1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b)(3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss. The presence of loss distinguishes the instant cause from *Bazley* v. *Commissioner, supra.*

At the initial argument and upon re-argument before the Third Circuit Court as well as in his briefs, petitioner submitted that the recognition of gain or loss with respect to the exchange herein involved was precluded by the application of Section 112(b)(3), as hereinafter proved under Point III, but that if it was concluded that the recognition of such gain or loss was *not* so precluded, then, no gain or loss was to be recognized because of the operation of Sections 112(b)(2), 112(c)(1) and 112(e) of the Code.

In the instant case, common stock in a corporation was exchanged for common stock and bonds in the same corporation. Were it not for the bonds, said exchange would fall completely within Section 112(b)(2), which provides that no gain or loss shall be recognized upon the exchange of common stock solely for common stock in the same corporation. However, where other property—that is, "boot" —is given in addition to stock, Sections 112(c)(1) and 112(e) become important. This type of exchange does not require a recapitalization.

Under Section 112(c)(1), if an exchange would be within Section 112(b)(2), precluding recognition of gain or loss, except for the fact that other property is given, then the *gain* to the recipient shall be recognized, but in an amount not in excess of the fair market value of such other property. Inasmuch as Section 112(c) concerns itself exclusively with the case where the fair value of the stock and boot exceed the basis of the stock surrendered in exchange therefor, it is accordingly inapplicable to the exchange herein, *which resulted in a loss.*

It should be noted that the undisputed facts herein show that the cost basis to the petitioner of his shares exceeded the fair value of the assets received by him in exchange therefor, resulting in a loss to him in the amount of $145,857.89, thereby distinguishing the instant cause from the *Bazley* case, where a gain was involved. The Tax Court, however, made no findings of fact with respect to such loss. We fail to perceive why it did not.

Having resulted in a loss, the exchange would be governed by Section 112(c). This section provides that if an exchange would be within Section 112(b)(2) if it were not for the boot, and if the exchange results in a loss, such loss is not to be recognized, even though the transaction involves boot.

The respondent advanced an argument in the court below which emasculates Sections 112(b)(2) and 112(c)(1). He contended that the new stock received in exchange herein was essentially the same as the old stock, that the equity interest of the taxpayer in the corporation was not altered, and that the stockholders in reality surrendered nothing in respect of the stock, but merely received the bonds, the equivalent of cash, in addition to what they had before, resulting in a dividend.

But those very consequences are envisaged by the statute. Certainly, upon an exchange of common stock solely for common stock or preferred stock solely for preferred stock in the same corporation as contemplated by Section 112(b)(2), the new stock will, of necessity, be essentially the same as the old and equity interests will remain unchanged. And when an exchange would be of that type *except that* property or the equivalent of cash or cash is, in addition, received by the taxpayer, then under Section 112(c)(1), *gain*, if any, is recognized in "an amount not in excess of the sum of such money and the fair market value of such other property". On the other hand, loss, if any, in the latter situation, would not be recognized. Section 112(e).

Neither the respondent nor the Courts below questioned the reality of the exchange herein of petitioner's common stock of par value for common stock of no par value, nor has the respondent or any court ever advanced the corporate business purpose test in Section 112(b)(2) situations.

Is not the instant exchange therefore completely within the statute? If the respondent's contention is adopted, is not the effect thereof to write those sections out of our revenue law?

Petitioner submits that the answer to these questions should be in the affirmative. The instant exchange is exactly the type Congress envisaged when those provisions were enacted, if held not to come within Section 112(b)(3).

Petitioner feels it incumbent to point to the naivetè of respondent in suggesting below that the reduction in the stated value of the stock could have been evidenced just as well, so far as the record shows, by book entries and a notation on the old certificates as by a formal exchange of stock (Brief for Respondent to C. C. A. 3, p. 30). The corporation law of New Jersey provides that, in order to accomplish

the steps herein taken, there must be a formal plan of recapitalization adopted by the Board of Directors and stockholders of a corporation and that a certificate setting the same forth must be filed with the Secretary of State (Revised Statutes of New Jersey (1937) 14:11-1, 2). The method suggested by respondent would not only violate the New Jersey statutes in such cases made and provided, but would be *ultra vires* the corporation.

It is clear, therefore, that even if the Third Circuit Court is correct in its conclusion that the recognition of gain or loss is not precluded by Section 112(b)(3), which is denied, the application of Sections 112(b)(2) and 112(e) precludes the recognition of loss and compels the very result for which petitioner contends. The Court's failure to consider the problems inherent in the latter sections has greatly prejudiced petitioner's position herein, and has resulted in grave injustice to him. The inequity of having something taxed to him as *a dividend* when the transaction resulted *in a loss* is manifest.

POINT III.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose (as distinguished from a shareholder purpose) to be within Sections 112(g)(1)(E) and 112(b)(3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering, supra.*

The Circuit Court of Appeals for the Third Circuit is the first appellate tribunal, so far as can be ascertained,

to inject into Sections 112(g) (1) (E) and 112(b) (3) the requirement that a recapitalization, to be within the non-recognition provisions, must have a corporate business purpose as distinguished from a shareholder purpose. *Bazley* v. *Commissioner*, *supra*.

There appears to be no legislative or judicial precedent for such requirement. There is nothing in the plain language of the statute which requires such a purpose. There is nothing in the legislative history of the foregoing sections which indicates that the enactors thereof intended that such purpose should be prerequisite to the invocation and operation of the sections. In fact, the whole doctrine is a fiction of the Tax Court, having been brought to light in recapitalization cases for the first time in *Louis Wellhouse, Jr.*, 3 T. C. 363 (1944).

A. The exchange herein involved falls within the exact tenor of Section 112(b)(3). Where a statute is clear and unambiguous on its face, resort to extraneous materials for the purpose of interpreting it is improper.

The Code clearly provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation. Section 112(b)(3). It is submitted that each and every element required for the non-recognition of gain or loss exists herein, and that the instant case is entirely within the tenor of said section.

That the plan of the Newark Theatre Building Corporation effected a "recapitalization" within Section 112(g)(1)(E) and therefor a "reorganization" has not been questioned by the Commissioner of Internal Revenue,

the Tax Court, or the Third Circuit Court of Appeals.[1] Likewise, that debentures constitute securities,[2] and that par value common stock in the corporation was exchanged solely for no-par value common stock and such securities within the framework of the existing corporation is not open to doubt. The evidence is clear that the exchange was a unitary, integrated exchange of petitioner's shares in the corporation for shares and securities in the same corporation, and that such exchange amounted to no more than the "reshuffling of a capital structure within the framework of an existing corporation". *Helvering* v. *Southwest Consolidated Corporation*, 315 U. S. 194, 62 S. Ct. 546 (1942); *Bass* v. *Commissioner*, *supra*. Authority is equally clear that such an exchange may not be broken into one exchange plus a distribution, or into a multiple exchange.[3] What was effected as to petitioner, was "a mere reshaping of his interest in the same corporation

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[1] On facts identical to those herein involved, the Board of Tax Appeals held this type of adjustment in capital structure to be a "recapitalization" and therefore a "reorganization". *Edgar M. Docherty*, 47 B. T. A. 462 (1942). Other decisions by the Board and courts in cases involving slight differences in fact, such as exchanges of a corporation's debentures for preferred stock, have held such to be a "recapitalization". *Annis Furs, Inc.*, 2 T. C. 1096 (1943); *Commissioner* v. *Capento Securities Corporation*, 140 F. (2d) 382 (C. C. A. 1st, 1944), aff'g 47 B. T. A. 691 (1942); *Clarence J. Schoo*, 47 B. T. A. 459 (1942), Commissioner's appeal dismissed (C. C. A. 1st, 1943).

[2] Decisions holding debentures "securities" are legion. *Edgar M. Docherty*, *supra*; *Clarence J. Schoo*, *supra*; *South Atlantic Steamship Line*, 42 B. T. A. 705 (1940); *Commissioner* v. *Neustadt's Trust*, 131 F. (2d) 528 (C. C. A. 2nd, 1942); *Commissioner* v. *Kolb*, 100 F. (2d) 920 (C. C. A. 9th, 1938). Neither Court below held otherwise.

[3] *Helvering* v. *Minnesota Tea Co.*, 89 F. (2d) 711 (C. C. A. 8th, 1937), aff'd 302 U. S. 609, 58 S. Ct. 393 (1938); *Starr* v. *Commissioner*, 82 F. (2d) 964 (C. C. A. 4th, 1936), cert. den. 298 U. S. 680, 56 S. Ct. 948 (1936); *Ahles Realty Corp.* v. *Commissioner*, 71 F. (2d) 150 (C. C. A. 2nd, 1934), cert. den. 293 U. S. 611, 55 S. Ct. 141 (1934).

through a recapitalization". *Schoo, supra,* page 461, citing *LeTulle* v. *Scofield*, 308 U. S. 415, 60 S. Ct. 313 (1940).

Each element required by the plain language of Section 112(b)(3) is here present, and for this reason it is submitted that gain or loss should not be recognized to petitioner. *Docherty, supra; Schoo, supra; Annis Furs, Inc., supra; Commissioner* v. *Capento Securities Corporation, supra; Bass* v. *Commissioner, supra; Jacob Fischer,* 46 B. T. A. 999 (1942).

Section 112(b)(3) is clear and unambiguous on its face. There is, in reality, no doubt about the meaning of any word or phrase used therein. Under such circumstances it is submitted that no judiciary body is justified in looking to extraneous source material for a construction of something about which there is no doubt, for the purpose of injecting a new requirement therein. Judge Opper, who wrote the majority opinion for the Tax Court below, recognized this in *Charles R. Brown*, 7 T. C. No. 86 (Docket No. 9146, 9/10/46), where, in construing Section 22(k) of the Code, he wrote: "The statutory command is thus so forceful and unambiguous that even were the legislative history more helpful we should not feel justified in resorting to it" (Slip Opinion, p. 2).

One might apply general principles of law in an analogous situation, to wit, where a contract is clear and unambiguous on its face, resort may not be had to extraneous writings of one of the parties to demonstrate that he did not intend the ordinary usage of the words in the contract.

It is submitted that inasmuch as Section 112(b)(3) is clear, definite and unambiguous on its face, and the instant case falls squarely within the tenor thereof, fundamental rules of statutory construction preclude the insertion therein of any additional requirement not enacted by Congress.

B. The legislative history of the reorganization sections herein involved and pertinent decisions clearly show that a corporate business purpose as distinguished from a shareholder purpose is not required.

There is nothing in the legislative history of Sections 112(b)(3) and 112(g) which implicitly or explicitly requires the presence of a corporate business purpose as distinguished from a shareholder purpose in order to qualify a reorganization for tax-free status within the terms thereof. The intent of Congress with respect to these sections was only to preclude "astute lawyers" from attempting "to take advantage of these provisions by arranging in the technical form of a reorganization, within the statutory definition, *what were really sales*". (Italics supplied.) House Ways & Means Committee, Rep. No. 704, Revenue Bill of 1934, 1939—1 C. B. (2) 554, 564. Section 112(b)(3) was introduced to permit flexibility in *bona fide, non-sham* adjustments of corporate capital structures without the imposition of tax. (See Point IV, A, *infra*, for a full discussion thereof.) Where a transaction purporting to be a reorganization is in fact a reorganization, Congress intends it to be given special treatment; but where a "taxable sale" or any other transaction not a reorganization is cast into the "form of a reorganization", preferential treatment is not to be accorded thereto.

This principle, and nothing more, was enunciated by this Court in *Gregory* v. *Helvering, supra,* the decision which allegedly establishes the necessity for a corporate business purpose as distinguished from shareholder purpose in reorganization transactions. In that case, petitioner sought to bring about a "reorganization" under

Sections 112(g) and 112(i)(1)(B) of the Revenue Act of 1928, set forth below.[4] In holding against the petitioner this Court stated at pages 469-470:

> "... It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States *v.* Isham, 17 Wall 496, 506, 21 L. Ed. 728; Superior Oil Co. *v.* Mississippi, 280 U. S. 390, 395, 396, 50 S. Ct. 169, 74 L. Ed. 504; Jones *v.* Helvering, 63 App. D. C. 204, 71 F. (2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. ...
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> "... Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having *no business or corporate purpose*—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize

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[4] "Sec. 112. • • • (g) Distribution of Stock on Reorganization. If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. • • •

"(i) Definition of Reorganization. As used in this section • • •

"(1) The term 'reorganization' means • • • (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred • • • 26 USCA Sec. 2112 (g), (i)(1)."

a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. . . .

". . . The whole undertaking, though conducted according to the terms of subdivision (B) was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." (Italics supplied.)

Six months after the *Gregory* case, the Circuit Court of Appeals for the Second Circuit in *Chisholm* v. *Commissioner*, 79 F. (2d) 14 (C. C. A. 2nd, 1935), cert. denied, 296 U. S. 641 (1935), interpreted the meaning of the decision in *Gregory* v. *Helvering*. The Court, at page 15, stated:

". . . It is important to observe just what the Supreme Court held in that case. It was solicitous to reaffirm the doctrine that man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. It is true that that Court has at times shown itself indisposed to assist such efforts, Mitchell *v.* Commissioner, 91 U. S. 206, and has spoken of them disparagingly, Shotwell *v.* Moore, 129 U. S. 590; but it has never, so far as we can find, made that purpose the basis of liability; and it has often said that it could not be such. *The question always is whether the transaction under scrutiny is in fact what it appears to be in form;* a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not

for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent but not the whole, transaction would realize. *In Gregory* v. *Helvering, supra, (293 U. S. 465), the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.*" (Italics supplied.)

The foregoing quotations indicate, without a doubt, that the basis of the holding of this Court in the *Gregory* case is that there was, in fact, no reorganization; it was all a façade. Had the reorganization not been "an elaborate and devious form of conveyance *masquerading* as a corporate reorganization" (italics supplied) and had "a reorganization in *reality*" (italics supplied) been effected, the result of the case would have been different. In fact, a different result was reached in the *Chisholm* decision where the petitioner and his brother organized a partnership, to which they transferred title to certain stock, in order to "postpone, and perhaps altogether escape, the taxes which would otherwise become due upon the sale" thereof. In holding for the petitioner, the Court said that although the partnership was formed confessedly to escape taxation, the association of individuals was in fact a bona fide partnership.

Regardless of motive or purpose, the intent of the Newark Theatre Building Corporation *was to effect a recapitalization* through an exchange of stock and debentures for outstanding stock. It did in fact implement its intent by consummating such an exchange; there was nothing illusory about it nor did it represent "artifice" as contrasted with "reality".

An analysis of cases more recently decided discloses that this Court has recognized and articulated the actual rule of *Gregory* v. *Helvering, supra,* in tax cases involving family partnerships. In *Tower* v. *Commissioner, supra,* and *Lusthaus* v. *Commissioner, supra,* this Court recognized and reaffirmed the legal right of a taxpayer to decrease his taxes by lawful means, but struck through the partnership therein involved as a mere superficial arrangement, something which did not exist in *reality,* inasmuch as there had been no change in the husband's economic interest in the business. The basis of these decisions is that there was no *real* partnership between the petitioner and his wife, it being merely "clothed in the outer garment of respectability."[5]

To the same effect in connection with a sale of property is *Commissioner* v. *Court Holding Company, supra,* where this Court struck through various sales negotiations as mere formalities designed to make the transaction appear to be other than what it was. This Court, citing the *Gregory* case, stated that a sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a *conduit* through which to pass title.

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[5] In fact, the Tax Court applied the actual *Gregory* rule to partnership cases, prior to the decisions in the *Tower* and *Lusthaus* cases. *Walter W. Moyer,* 35 B. T. A. 1155 (1937); *J. D. Johnston, Jr.,* 3 T. C. 799 (1944); *Robert P. Scherer,* 3 T. C. 776 (1944); *Felix Zukaitis,* 3 T. C. 814 (1944); *M. W. Smith, Jr.,* 3 T. C. 894 (1944).

Decisions with respect to transactions involving corporate recapitalizations, except recent ones of the tax Court, have been in the same vein. Holdings by this Court and the Federal courts bear out petitioner's contention that the *Gregory* case does not require that a reorganization, in order to be effective tax-wise, must have a corporate business purpose as distinguished from a shareholder purpose.[6] In fact, it is submitted that this Court's decision in *John Kelley Company* v. *Commissioner, supra,* completely undermines the respondent's position in that respect.

In the *Kelley* case, the taxpayer-corporation had an authorized capitalization, on January 1, 1937, of 1,500 shares of no par common stock and 3,000 shares of 6% cumulative preferred stock of $100.00 par value, of which 1,110 of the common and 1,124 of the preferred were outstanding. All of the stock was owned directly or indirectly by members of a family group. On January 11, 1937, the corporation adopted a plan of recapitalization pursuant to which the common stock was changed to $100.00 par value and increased to 6,000 shares. In addition, twenty-year "income debenture bonds," aggregating $250,000.00 and bearing annual interest of 8%, were authorized. Payment of interest was conditioned upon the sufficiency of the net income of the taxpayer to meet the obligation. Debentures were issued in the amount of $150,000.00 face value, the greater part thereof, or $114,648.00, being exchanged for the original preferred stock, and the balance thereof being

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[6] *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, 56 S. Ct. 269 (1935); *Griffiths* v. *Commissioner*, 308 U. S. 355, 60 S. Ct. 277 (1939); *National Investors Corp.* v. *Hoey*, 144 F. (2d) 466 (C. C. A. 2nd, 1944); *Electrical Securities Corp.* v. *Commissioner*, 92 F. (2d) 593 (C. C. A. 2nd, 1937); *Commissioner* v. *Gilmore's Estate*, 130 F. (2d) 791 (C. C. A. 3rd, 1942).

sold to the common stockholders. Common stock was owned in the same proportions by the same stockholders before and after the reorganization.

The Commissioner determined deficiencies in tax for the calendar years 1937, 1938, and 1939, by virtue of a disallowance of taxpayer's deduction of payments made in each of said years on the debentures as interest on indebtedness.

The Commissioner contended that the payments were dividends under Section 115(a) of the Revenue Act of 1936 and not interest within the meaning of Section 23(b).

In holding for the taxpayer and against the Commissioner, this Court stated that there was not present in the *Kelley* "situation the wholly *useless temporary* compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering*, 293 U. S. 465" (Italics supplied). This Court then went on to consider the characteristics of the obligations in question, and to determine that the indicia thereof supported the conclusion that they were an indebtedness.

It is submitted that said decision is of momentous importance with respect to the instant cause because of their parallelism and should, accordingly, guide this Court in its determination herein.

It is to be noted that the Commissioner in the *Kelley* case urged the *Gregory* decision upon this Court in support of the underlying theory that no effect was to be given to the reorganization involved therein, and that, consequently, what purported to be bonds were not bonds nor were the sums distributed interest on such bonds, but dividends on stock. This Court interpreted the *Gregory* decision adversely to the Commissioner, and favorably to the taxpayer, stating that *useless* and *temporary* compliance

with the statute characterizes a *Gregory* situation. In other words, this Court's decision is predicated on the notions that a reorganization was in fact consummated, that pursuant thereto, bonds were issued in exchange for preferred stock, that there was nothing useless about the reorganization and that it was characterized by some degree of permanency. With these fundamental assumptions in mind, this Court then proceeded to consider whether the ingredients of the obligations were such as to permit of the deductibility of payments thereon as interest.

The Commissioner's approach in the case at bar is similar. He is, in reliance on the *Gregory* decision, urging that no effect be given to the reorganization. Certainly, a plan of reorganization was adopted herein and consummated according to the terms thereof. Genuine stock and bonds were issued in exchange for the old stock. There was, indeed, no useless compliance with the statute, such compliance resulting in the savings of thousands of dollars in income and franchise taxes, as hereinafter set forth in Part C hereof. Nor can it be said that compliance was temporary, inasmuch as the bonds herein were issued and are still outstanding.

Even the Tax Court, prior to the creation of its fiction, held the same way in recapitalization cases. In the *Schoo* case, *supra*, the Board of Tax Appeals stated at page 462:

> "There is nothing in the circumstances to invite the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465. . . . The recapitalization is not a sham or an artificial detour around a taxable event. There is nothing to indicate that a devious form of corporate maneuvering was masquerading as a recapitalization in order to avoid a tax which would have been assessed if the transaction had been permitted to take its direct course."

This was said by the Board *even though the purposes of the reorganization, as stated by the president of the corporation to its shareholders, included a reduction in transfer taxes, as well as in income tax by the issuance of bonds.* Similarly the Board in the *Docherty* case, *supra*, stated at page 464:

> "There is nothing to arouse the application of the doctrine of *Gregory* v. *Helvering*, 293 U. S. 465, for the recapitalization was a bona fide readjustment of the corporation's financial structure for a legitimate business purpose. The evidence to that effect is entirely credible and there is neither fact nor circumstance to throw it in doubt."

From the foregoing decisions, it is clear that *the end* that is sought to be accomplished by the taxpayer is the important thing, regardless of the *motive* therefor. Judicial concern is whether a reorganization, or a partnership, or a sale or the issuance of a bond, as the case may be, has in actuality been effected. Once this actuality has been effected, the motive therefor, "whether to avoid taxes, or to regenerate the world," is immaterial.

The whole question has been excellently stated and discussed by Judges Maris and Goodrich in their dissenting opinion in *Bazley* v. *Commissioner*, *supra*, adopted by them with respect to the instant case. It is in great measure now quoted:

> "The . . . question is whether a corporate reorganization, in order to be tax free, must be one conducted for a 'corporate business purpose' of the corporation as distinguished from serving a proper business interest of the shareholders. . . .
>
> "We think that the criterion here making a distinction between 'corporate' and 'shareholder' purpose is incorrect. The foundation for it is supposed to be Gregory *v.* Helvering, 293 U. S. 465 (1935). That

case involved the formation of a dummy corporation which did no business otherwise than to participate in a transfer which the taxpayer was seeking to effect without tax liability. What we had was a sale masquerading as a reorganization. The court struck through the sham.

"To expand that decision into a rule of law such as is now contended for is to push it beyond anything which we think the court could have had in mind. Nor do we think the expansion is one which a reasonable growth beyond Gregory *v.* Helvering would call for. We have long since passed the place in our thinking where we view the corporation as 'an artificial being, invisible, intangible and existing only in contemplation of law'. We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders. Shareholders, of course, may have conflicting interests among themselves with regard to the conduct of their common enterprise. They may fight with each other, perhaps, in order to elect A instead of B to the directorship of their company. And, of course, aside from their interest in the common enterprise, called their corporation, they have interests as varied as the hopes and desires of human beings. But when we talk about the interest of shareholders in connection with the business enterprise and have a finding of fact that such and such a thing was done and that it was to the shareholders' business advantage, speaking of them as a group, we do not find substance in a distinction between the business advantages of the shareholders with respect to the corporation or the business advantages of the corporation itself.

"Furthermore, this very thing concerned with here, reorganization, is a matter in which shareholders directly participate. The day to day busi-

ness of the corporation is done by its officers, directors, employees. But a realignment of the interests in the enterprise through reorganization must come, under every corporation law we know of, through vote of the shareholders. In such circumstances it is as a practical matter impossible to separate as to the very transaction involved a 'shareholder's' from a 'corporate' interest.

"We think the distinction attempted coming, as it does, quite a number of years after Gregory *v.* Helvering, is one not established by that decision, the statute, nor the regulations. If reorganization provisions contain too many avenues of escape for taxes which ought to be collected the Congress can close those avenues by appropriate legislation which can be so framed and defined as to leave the way clear to what it deems are business transactions in which no gain or loss should be recognized. We do not think it should be by judicial decision which establishes the exceedingly vague criterion as to whether a given transaction was to the interest of the shareholder as distinguished from the interest of the corporation in which he holds shares of stock.

"The gloss here sought to be placed upon those provisions of Section 112 of the Internal Revenue Code which render nontaxable the exchange of certain securities in connection with corporate reorganizations; can only be justified upon the assumption that all reorganizations which are put through by stockholders solely to promote their own business purposes must necessarily involve the motive of tax avoidance. Only upon this assumption can the principle of Gregory *v.* Helvering be applicable. But this assumption is quite unsound as the facts of the case before us demonstrate. And even clearer cases can readily be brought to mind. Suppose a case in which the common shareholders arrange for the reclassification of a part of their holdings as non-vot-

ing stock in order that they may sell it or give it away without endangering their voting control. This would be a perfectly proper business purpose of the stockholders involving not a trace of tax avoidance, but it would not benefit the business of the corporation as such. We do not think that there is any authority for the proposition that such a recapitalization would not be within both the letter and the spirit of Section 112."

Petitioner submits that certain overall conclusions are inescapable. There is nothing in the plain language of the statute which requires a corporate business purpose. There is nothing in the legislative history of the reorganization provisions (as outlined hereinabove and in Point IV, A, *infra*, regarding Section 112(b)(3)) which indicates that the enactors thereof intended that such purpose should be a prerequisite to the invocation and operation of the sections. This Court's decision in *Gregory* v. *Helvering*, while outlawing sham transactions, does not establish the necessity for a corporate business purpose as distinguished from shareholder purpose in non-sham reorganization transactions, and this Court, the Federal courts, and the Board of Tax Appeals in other cases have not read the requirement therefor into that decision. Even the Tax Court has conformed to this extent in its treatment of partnership cases.

It is submitted that the corporate business purpose doctrine, as applied to reorganization transactions (and particularly to recapitalizations), is a fiction of the Tax Court. It is further submitted that should the doctrine be allowed to continue in its present form, rules of law will be supplanted by rules of men. The Tax Court will virtually go into business, and substitute its subjective judgment, based on hindsight, for objective rules of law, in the determination of what is or is not a corporate business purpose.

The doctrine should be relegated to the limbo before it is allowed to do further harm to the business world that needs must follow from the uncertainty which it creates.

C. The instant plan of reorganization was adopted and effectuated for legitimate business purposes, including corporate and shareholder purposes. The Tax Court found such purposes to be present herein.

At the outset, petitioner desires it to be noted that he is not asking this Court to make separate or different findings of fact as to the purposes for the plan of recapitalization. Petitioner bases his contention herein upon those very purposes found and considered as facts by the Tax Court. *Dobson* v. *Commissioner, supra.* Even if this Court should conclude that the presence of a corporate purpose as distinguished from a shareholder purpose is necessary to give effect to a reorganization within the terms of the statute, petitioner submits that corporate business purposes are herein present and that the Tax Court found same as facts.

The uncontradicted testimony herein as well as the findings of fact by the Tax Court in both the earlier and superseding opinions are to the effect that the purposes of the plan of recapitalization included the saving of New Jersey franchise taxes in excess of $400.00 per year as well as the reduction of the Corporation's federal income tax liability by the deduction of interest paid on the bonds (R. 86a, 97a). It is submitted that these purposes are sufficient to bring the Corporation within the sanctuary of a tax-free "reorganization", and that the Tax Court was in error, as a matter of law, in holding otherwise.

As Judges Goodrich and Maris pointed out, a corporation is today not considered a being which is invisible, intangible and existing only in law. It is a device which share-

holders use to carry on a business as a group. It is axiomatic in our present day economy that the primary purposes of all commercial corporations are the realization of profit and the distribution of such profit to the investors who have contributed their capital to the corporation. It is recognized that increased profits are realized by any reduction of expense, that a reduction of expense is accomplished by a diminution in tax burden, and that a diminution in corporate tax burden may constitute a legitimate business purpose of a reorganization. *Clarence J. Schoo, supra.* See also *C. A. Munroe,* 39 B. T. A. 685 (1939); *Tower* v. *Commissioner, supra;* and holdings by the Third Circuit Court in *Meurer Steel Barrel Co.* v. *Commissioner,* 144 F. (2d) 282 (C. C. A. 3rd, 1944); *Commissioner* v. *Day & Zimmerman,* 151 F. (2d) 517 (C. C. A. 3rd, 1945). So also does a reduction in the corporation's liability for dividends or interest constitute a legitimate business purpose. *Annis Furs, Inc., supra.* Furthermore, Judge Kern of the Tax Court has recognized, and, it is submitted, rightfully so, that even where, as here, the reduction in a corporation's tax liability gives rise to an increase in liability for interest on the bonds in an equal or greater amount, a legitimate corporate business purpose is present where the investors of the corporation receive a greater distribution of money in the form of dividends and interest than they received as dividends prior to the recapitalization.

The Tax Court, however, has seen fit to introduce a further refinement into the statute, without any warrant therefor, by stating that a corporate business purpose must be of benefit to the corporation. The Tax Court has thus extended the doctrine of the corporate business purpose, in itself a fiction, to the point where something which is a purpose is not treated as a purpose unless it is of benefit

to the corporation. The Tax Court accordingly rejected the savings of income tax by the corporation as a corporate business reason, by virtue of the alleged disadvantage to the corporation in undertaking an annual obligation to pay interest on a sum of money in order to obtain a tax reduction in a smaller amount.

The correctness of the Tax Court's theory that where the reduction in the corporation's income tax liability is accomplished by an increase in liability for interest in an equal or greater amount, the reduction in tax liability cannot be said to be a corporate business purpose, is questioned for two reasons.

In the first place, if this argument were carried through to its logical and inevitable conclusion, the issuance of bonds for stock in a recapitalization could *never* be a corporate business purpose of benefit to the corporation because the recapitalization will always result in the creation of a liability where none existed previously. Even the Tax Court has recognized this. In *Annis Furs, Inc., supra,* shares of 6½% cumulative preferred stock were exchanged in a recapitalization for 6% debenture bonds. Said the Tax Court: "It cannot be said * * * that this recapitalization served no reasonable or legitimate business purpose, for the reduction of the corporation's periodic charge from 6½%, as the dividend was under the preferred shares, to 6% as the interest became under the debentures, was a sufficient financial advantage to explain and justify the change." (p. 1098). Thus, the Tax Court found business purpose even though, pursuant to the recapitalization, a liability in the form of bonds outstanding was created, whereas prior to the recapitalization there was no such liability. The existence of cumulative preferred stock merely defines the rights, privileges and preferences as

between proprietary interests; there exists no corporate obligation until dividends are declared. The issuance of bonds, however, creates a definite obligation and liability to creditors, from the moment of issuance. It is submitted that if the Tax Court is followed in this respect, Section 112 (b)(3) will be emasculated.

In the second place, the proposition of the Tax Court overlooks a fundamental principle of economics and finance, to wit, that under certain circumstances, it may be a business purpose of benefit to the corporation to borrow money from outsiders for the conduct of its business even where the amount of tax saved is less than the liability created for interest commitments. This may be illustrated by an example. Suppose that A and B organize a corporation to operate a business which will require an investment of $100,000.00, and that the risk of this type of business requires a 20% return on capital. Assume that they are offered a $50,000.00 loan by outsiders, but desiring a closed corporation, they invest the $100,000.00 from their own funds. Their yearly return on their investment will be $20,000.00. Suppose, however, that the corporation originally takes advantage of the $50,000.00 loan offered, and issues common stock to A and B in the amount of $50,000 and 6% bonds to outsiders in the amount of $50,000. The corporation now has outstanding bonds payable in the amount of $50,000.00 and capital stock of $50,000.00. The corporation's net profit for the year, after the deduction for interest on the bonds in the amount of $3,000.00 (6% of $50,000.00), is $17,000.00. Although the latter amount is less in total figure, such yield is on the basis of an investment of $50,000.00. Whereas, prior to the recapitalization the yield upon the common stock was 20% ($20,000.00 return on $100,000.00), the yield subsequent thereto has in-

creased to 34% ($17,000 return on $50,000.00). It is apparent that such an increased yield per share inures to the benefit of the investor as well as to the corporation. The investor receives a greater return on his investment; the corporation now has outstanding stock of far greater salability. It is submitted that the majority opinion of the Tax Court did not take cognizance of the foregoing expedient of trading on the equity or implementing financial leverage—using other people's money—in the consideration of this phase of the instant cause. Had the majority considered this principle, they could not have stated that if "the money were to be borrowed from strangers, it seems evident that this could not but be a losing transaction for the corporation." (R. 103a).

But even if there is some basis for the Tax Court's holding in that respect, which is denied, *the Court did not answer petitioner's argument that the Corporation also effected a saving in state franchise taxes. It cannot be gainsaid that such savings constituted a corporate business purpose, and that such purpose was of benefit to the Corporation.* Notwithstanding any statement to the contrary by respondent, the Tax Court did not reject this purpose as being of no benefit to the Corporation. The Court in fact neglected to do more than mention the franchise tax issue in its opinion (R. 103a), without disposing of it. Petitioner reiterates that the saving to the Corporation has already exceeded $2,000 since the date of the reorganization and will continue at the rate of $413.98 each and every year during its existence. This purpose, in and of itself, suffices as a corporate business purpose, however such phrase may be defined.

The last purpose for the recapitalization found and considered as a fact by the Tax Court in the instant cause

was that petitioner wished to give bonds of the Corporation to his two sons, who were associated with him in the business, without surrendering any of his stock control over the company (R. 98a, 102a-103a). Although the Tax Court dismissed this reason as a personal one, having no connection with the corporate business, this purpose is equally consistent with the petitioner's desire to preserve continuity of control for the benefit of the corporation's business by giving away a non-proprietary interest therein.

Petitioner submits that the foregoing purposes are sufficient to bring the recapitalization herein within the provisions of Section 112(b)(3), whether or not a corporate business purpose as distinguished from a shareholder purpose is required. Petitioner submits, further, that even if corporate business purpose of benefit to the corporation is required, there is at least one such purpose herein which meets all the refinements presently injected into the statute, and that the recapitalization should be given effect on that basis.

POINT IV.

There is no basis for the holding of the Third Circuit Court, affirming the decision of the Tax Court, that the reorganization herein gave rise to a distribution essentially equivalent to the distribution of a taxable dividend under Section 115(g) of the Internal Revenue Code.

The majority opinion of the Tax Court, affirmed by a majority of the Third Circuit Court, is based on the premise that the reorganization herein amounted to a distribution and that "the distribution was a dividend or its essential equivalent," as envisaged by Section 115(g) of the Code.

It is submitted that there is no basis whatsoever for such a conclusion. Moreover, there was no distribution of a dividend within Section 115(a).

A. The legislative history of Sections 112(b)(3) and 115(g) furnishes proof that the instant transaction is not governed by Section 115(g).

Although the present terminology of Section 112 (b)(3) first appeared in Section 203(b)(2) of the Revenue Act of 1924, its roots can be found in the Revenue Acts of 1918 and 1921.[7]

Congressional intent and purpose with respect to the reorganization provisions are best gleaned from an examination of the contemporaneous reports of the committees considering them. Thus, Section 202(b) of the Act of 1918 was "designed to establish the rule for determining taxable gains in the case of exchanges of property and to negative the assertion of tax in the case of certain purely paper transactions". Senate Finance Committee, Rep. No. 617, Revenue Bill of 1918, 1939—1 C. B. (2) 117, 120. The Committee pointed out that when in connection with the reorganization of a corporation, a person receives in place of

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[7] Section 202 of the Act of 1918 contained provisions pertaining to the recognition of gain or loss, subsection (b) thereof providing that "when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged".

Section 202(c)(2) of the Act of 1921 provided that no gain or loss shall be recognized when, "in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization."

stock or securities owned by him new stock or securities of no greater aggregate par value, no gain or loss shall be deemed to occur from the exchange. Senate Rep. No. 617, *supra*.

New and explicit rules for the determination of gain or loss upon exchange transactions were introduced into the Revenue Act of 1921 to eliminate "many technical constructions which are economically unsound" and to "permit business to go forward with the readjustments required by existing conditions". Senate Finance Committee, Rep. No. 275, Revenue Bill of 1921, 1939—1 C. B. (2) 181, 189; House Ways & Means Committee, Rep. No. 350, Revenue Act of 1921, 1939—1 C. B. (2) 168, 176. Both Congressional committees recognized that the law as it then existed made a presumption in favor of taxation and that the Act under consideration modified that presumption in exchange transactions. Section 202(c) provided "new rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit". Senate Rep. No. 275, *supra*, at 188. The policy adopted by Congress of exempting from tax the gain from exchanges made in connection with a reorganization in order that ordinary business transactions would not be prevented was similarly recognized in discussions regarding the Revenue Act of 1924. House Ways & Means Committee, Rep. No. 179, Revenue Bill of 1924, 1939—1 C. B. (2) 241, 251; Senate Finance Committee Rep. No. 398, Revenue Bill of 1924, 1939—1 C. B. (2) 266, 276.

With the foregoing as a background, the full import of the words of Judge Arundell of the Tax Court in his dissenting opinion are more readily comprehensible and appreciable. Indeed, the "so-called corporate reorganization provisions of the revenue acts were designed to permit some

flexibility in the financial set-up of corporations without the present imposition of a tax due to such changes. It was recognized that our capitalistic economy could not properly function if it was kept in a strait-jacket, as it most surely would be if a tax consequence resulted with every change in the financial structure. Thus, recapitalizations were permitted without the present recognition of tax, leaving the imposition of the tax to the time when the exchanged security should be finally disposed of. No one contends that if the recapitalization is, in fact, a fraud or sham it is to be recognized . . ." (R. 110a).

It is clear, therefore, that the genesis and growth of the reorganization provisions of our revenue law are such as to make the transaction under consideration entirely within the compass thereof.

On the other hand, a parallel investigation of the legislative history of Section 115(g) proves as conclusively that it is not applicable to transactions such as the instant one.

The reason for the introduction into our revenue laws of Section 115(g) and its antecedent provisions can be traced back to the decision of the Supreme Court in *Eisner v. Macomber, supra*, in which it was held that a dividend of common stock upon common stock did not give rise to taxable income. The effect of Section 201(d) of the Revenue Act of 1921 and Section 201(f) of the Revenue Act of 1924 was that, although a stock dividend was stated not to be subject to tax, a taxable dividend was said to exist if *before or after the distribution of any such dividend*, the corporation redeemed its stock at such time and in such manner as to make the distribution essentially equivalent to the distribution of a taxable dividend. Congress intended to provide for the case in which a corporation first redeems a portion of its stock and then declares a stock dividend as

well as the case in which the corporation first declares the stock dividend and then redeems a portion of its stock. (See Senate Finance Committee, Report No. 275, Revenue Bill of 1921, 1939-1 C. B. (2) 181, 187; Ways and Means Committee, Report No. 179, Revenue Bill of 1924, 1939-1 C. B. (2) 241, 250; Senate Finance Committee, Report No. 398, Revenue Bill of 1924, 1939-1 C. B. (2) 266, 275).

It can thus be seen that the genesis of the presently designated Section 115(g) of the Code is steeped and inextricably enmeshed in considerations emanating from the stock dividend consciousness of Congress, and that the sections of prior revenue acts corresponding thereto "were enacted by Congress in an attempt to prevent the avoidance of tax upon distributions of corporate earnings, ordinarily to be distributed as dividends and so taxable, by means of redemption and cancellation of stock." *Annie Watts Hill*, 27 B. T. A. 73, 75 (1932), aff'd. 66 F. (2d) 45 (C. C. A. 4th, 1933); *Leopold Adler*, 30 B. T. A. 897, 905 (1934), aff'd 77 F. (2d) 733 (C. C. A. 5th, 1935).

Congress subsequently recognized the potentialities of partial liquidations for tax evasion purposes, and attempted to control the incidents thereof. This it did by writing into the Revenue Act of 1926 an all-inclusive provision giving the Commissioner plenary power to protect the revenues against tax evasion practices consisting of the redemption of stock "whether or not such stock was issued as a stock dividend." (Section 201(g) of the Revenue Act of 1926).

Nowhere does it appear that Congress intended Section 115(g) to apply to recapitalizations or to situations where a corporation's own bonds were issued in connection therewith.

B. The law and the applicable regulations demonstrate that the instant transaction cannot be governed by Section 115(a).

Section 115(a) provides in general terms that a "dividend" is any distribution by a corporation to its shareholders. The word "distribution" is not defined in the statute. Reference to the regulations indicates that the term "dividend" comprises any distribution *in the ordinary course of business.* Regulations 103, Section 19.115-1.

It is evident that the instant transaction does not fall within Section 115(a). In the first place, there was here an *exchange,* not a distribution, however the latter may be defined. That there is a distinction between the terms "distribution" and "exchange", and that the former does not include the latter, is evidenced by Section 115(c) which provides that in certain instances (notably, liquidations), a *distribution* is to be treated as payment in *exchange* for the stock. But for that specific provision, there would be no affinity between those concepts. In the second place, even if there existed a "distribution" in the instant cause, which is denied, there was no such distribution as to constitute a "dividend" inasmuch as what was herein effected was not done in the ordinary course of business.

In view of the foregoing, it is submitted that the common acceptation of the meaning of "distribution" must be attributed thereto. Its derivation from the Latin prefix "dis" meaning "apart" and the verb "tribuo" meaning "give" indicates the true definition thereof. The term connotes the *segregation* of corporate earnings and their *transfer* to stockholders. *Eisner* v. *Macomber, supra.*

In the instant cause, there was no segregation of earnings and there was no transfer or distribution thereof.

On past occasions, the Tax Court has indicated the necessity of a declaration as requisite to the presence of a divi-

dend. *Wellhouse, supra.* The facts herein certainly show the absence of any such declaration.

Petitioner submits that the foregoing illustrates the inapplicability of Section 115(a) to the instant exchange.

C. Judicial precedents with respect to Sections 112(b)(3) and 115(g) illustrate the inapplicability of Section 115(g) to the instant transaction.

The malapropoism of Section 115(g) herein is evidenced by recapitalization cases as well as typical 115(g) cases.

In *Louis Wellhouse, Jr., supra,* the petitioners exchanged 400 shares of common stock, which were then cancelled, for 400 shares of preferred stock in the same corporation, and subsequently paid off their personal debts. No change was made in surplus. Although the Tax Court held that there was no reorganization with corporate business purpose sufficient to cause nonrecognition of gain or loss under Sections 112(b)(3) and (g)(1) of the Code, it specifically denied the applicability of Section 115(g) with respect to the new preferred stock. The Court based its holding on the fact that there was no distribution out of earnings or profits, and that the surplus account remained unchanged in amount. The Court said that "section 115(g) is limited to a distribution out of earnings and surplus" (p. 370). As has been previously pointed out, there was no change in the earnings and profits, or surplus, account of the Newark Theatre Building Corporation.

In rejecting the applicability of Section 115(g) to the reorganization involved in the *Wellhouse* case, the Tax Court relied upon *H. Y. McCord,* 31 B. T. A. 342 (1934). There, the corporation involved reorganized its capital structure by exchanging 4,000 shares of common stock outstanding for 500 shares of common and 750 shares of preferred stock. In holding the recapitalization to be within

the statutory definition of a reorganization, the Board of Tax Appeals stated that no "question arises under Section 115(g) because, as we have seen, *the cancellation of outstanding shares was not for cash, but only in exchange* for new common and preferred shares" (p. 343) (italics supplied).

The same result was reached by the Tax Court in *Annis Furs, Inc., supra,* where shareholders surrendered their 6½% preferred stock in exchange for the corporation's 6% debentures. The Court determined that the exchange was a statutory reorganization upon which gain was not recognized, pursuant to Section 112(b)(3) of the Code, and that the exchange did not result in a distribution essentially equivalent to the distribution of a dividend under Section 115(g).

Other cases involving a recapitalization which rejected the Commissioner's attempt to foist a Section 115(g) argument upon the Court are *South Atlantic Steamship Line, supra; Skenandoa Rayon Corporation,* 42 B. T. A. 1287 (1940), aff'd. 122 F. (2d) 268 (C. C. A. 2nd, 1941); and *Jacob Fischer, supra.*

Approaching the problem from the 115(g) viewpoint, we find that the characteristic ingredients which generally have been held by courts to constitute redemptions and cancellations as being essentially equivalent to the distribution of dividends are totally lacking in the instant case. The well-known Section 115(g) criteria of taxability are absent, as are the time and manner of the cancellations pointing to essential equivalence.[8] Nor have taxable consequences been found in Section 115(g) decisions as the result of distribu-

[8] For a comprehensive treatment of the section and cases thereunder, see Sydney A. Gutkin and David Beck, "Stock Redemptions As Taxable Events Under Section 115(g): The Impressionistic Test", *Journal of Accountancy,* October 1945.

tions of the stock or bonds of the issuing company in, or with respect to, reorganizations.

What the Tax Court is here attempting is to take a Section 112 transaction out of the compass of that section and to force it into the mold of Section 115. This is in direct violation of the language of the Supreme Court. *Commissioner* v. *Estate of Bedford, supra.*

D: Section 115(g) is essentially a liquidation provision, thereby being inapplicable herein.

The terminology of Section 115(g) indicates that the situations envisaged thereby are those involving the cancellation or redemption of stock. In other words, the section is invoked where there is a partial liquidation of a corporation by the elimination of part of its total outstanding capital stock through redemption or cancellation.

In the instant case, however, there was no such "liquidation." Although technically, of course, there was a cancellation of the old shares upon their surrender, in reality, there was an *exchange* of an equal number of old shares for new shares. There was no redemption or cancellation of part of an outstanding issue in the sense that a balance of that outstanding issue remained, nor was there a complete cancellation or redemption of a portion of its outstanding stock.

It is accordingly submitted that Section 115(g) is not applicable herein.

E. The application of Section 115(g) to the instant transaction distorts the facts herein as well as the intention of the parties.

The facts in the instant case are clear that the Corporation intended to reorganize, and did reorganize by having the stockholders thereof exchange their par value common

shares for a like number of no par shares and debenture bonds. Judge Kern, who presided at the hearing of the instant cause and who was, accordingly, in a position to observe the demeanor of the petitioner and witnesses and to form a first-hand opinion, found that as a fact. Neither the majority of the Tax Court, nor the judges dissenting, found the recapitalization to be a fraud or a sham. A permanent change in the capital structure was intended and effected by the reorganization, which is the way the Corporation could have been initially organized, without criticism and without tax consequences. Judge Arundell aptly characterized the situation by stating that "*it was never intended that the tax collector or, indeed, a member of this court should pass on the wisdom or desirability of a corporate recapitalization. If what was done here was genuine and was not a sham, the test of the statute has been met.*"

It is submitted that the majority of the Tax Court was not justified in finding that no reorganization within the statutory definition was here accomplished when all the facts and the intent of the parties indicate otherwise. As previously indicated, there was no intent to declare a dividend, none was in fact declared, there was no change in the surplus account, and as much remained available for future distribution, in the accounting and economic sense, subsequent to the exchange as prior thereto.

POINT V.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111, 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941.

At the initial argument and upon re-argument before the Third Circuit Court, as well as in his briefs, petitioner submitted that the exchange of the Corporation's par value stock for new stock and debentures, of necessity, had to fall within one of three spheres: either it is (1) a tax-free reorganization within Sections 112(b)(3) and 112(g)(1)(E), upon which gain or loss is not recognized; or (2) it is a boot transaction upon which there is loss, said loss not being recognized, pursuant to Sections 112(b)(2) and 112(c), as contended under Point II; or (3) it is an exchange upon which gain or loss is recognized, subject to treatment as a capital gain or loss, pursuant to Sections 111, 112(a) and 117 of the Code.

Petitioner argued before the Circuit Court, and now reiterates, that if it is found that the exchange herein constituted an exchange requiring the computation of the realized gain or loss under Section 111, then the extent to which such "realized" gain or loss is to be "recognized" is determined by Section 112 and the extent to which such "recognized" gain or loss is to be taxed is determined by Section 117.

If, therefore, the recapitalization herein falls within the third category enumerated above, petitioner submits that he sustained a loss therefrom in the amount of $145,857.59, which is deductible as a long-term capital loss. Accordingly, petitioner overpaid his tax in 1941 by approximately $20,000.00.

It is not deemed necessary to repeat at length what appears in the Record and with respect to which the Tax Court made no findings of fact. With respect to the cost basis of petitioner's stock, this has been shown to be $417,944.28. The total fair value of the properties received by petitioner upon the exchange herein, appraised from a reproduction and replacement standpoint, was in the amount of $469,837.00. The total fair value of said properties appraised on the basis of capitalization of gross rental, was in the amount of $515,284.00. The petitioner has deemed it fair to average the valuations for the properties by dividing the total thereof, $985,121.00, by two, thereby deriving the quotient of $492,560.00. This last figure represents the fair value of the two parcels of real estate as of the time of the recapitalization.

The other assets of the Corporation, as per its Balance Sheet as at December 31, 1940, were in the amount of $84,923.49. The total assets were therefore in the amount of $577,483.49.

From said total assets are to be deducted mortgages payable on said parcels of realty in the amount of $291,250.00, in addition to other liabilities in the amount of $14,146.80 or a total of $305,396.80.

The difference between the total assets and total liabilities represents the net value of the Corporation's assets on recapitalization. This figure is $272,086.69.

Since the cost basis of petitioner's stock has been established at $417,944.28, and the fair value of the property

received in exchange therefor has been shown to be $272,086.69, the loss to petitioner is the differential, or $145,857.59.

The equity, accuracy and inevitability of this result can be more fully appreciated after reference to Section 115(c) of the Code, which expressly provides that the complete liquidation of a corporation shall be regarded, as to stockholders, as an *exchange* of their stock for the assets of the corporation, and that gain or loss represented by the difference between the value of the assets received and the basis of their stock upon such exchange is to be determined under Section 111, recognized only to the extent provided in Section 112, and taxed at the capital gain rates provided by Section 117.

Petitioner, as the dominant stockholder, could have liquidated the company, thereby securing all its assets, and could have sustained and deducted a loss (and escaped all tax) on the transaction by exchanging assets of a greater cost than the value attributable to the assets received. He could then have conveyed the assets to a new corporation in exchange for precisely the stock and debentures which he received in the instant recapitalization, and would then have held stock and bonds on the basis of their combined value. He would have been liable for no further tax on their sale at such value or their redemption.

As it is, the petitioner has done no more than to postpone the recognition of a loss until the actual sale or exchange of the bonds.

However, should this Court find that the exchange is one upon which gain or loss is recognized, petitioner accordingly submits that the instant cause should be remanded to the Tax Court for further findings with respect to the loss in the amount of $145,857.59, and for a determination regarding petitioner's overpayment of tax.

POINT VI.

The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court.

The Sixteenth Amendment to the Constitution of the United States invests Congress with the power to lay and collect taxes on "incomes", from whatever source derived, without apportionment among the several States and without regard to any census or enumeration. Section 22 of the Internal Revenue Code, and the applicable regulations, define income to include all *gains* derived from capital, from labor, or from a combination of both. Both the Constitution and the statute require that there must be a realization of income before tax incidents with respect thereto may ensue.

There have been suggestions in some cases that bonds issued in connection with a recapitalization, allegedly without business purpose, are not to be treated as bonds but are to be treated in the same manner as the stock given up in exchange therefor. *Commissioner* v. *Kelley Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944), rev'd. on another ground, 66 S. Ct. 299 (1946). If this is so, there can be no realization of income herein in either the statutory or constitutional sense if the Commissioner's contention is correct that no corporate business purpose was served by the recapitalization in question.

If what was issued by the Corporation was stock and not bonds, then nothing more was accomplished than a proliferation of capital, sans taxable consequences. *Eisner* v. *Macomber, supra; Strassburger* v. *Commissioner, supra; Helvering* v. *Griffiths, supra.*

Accordingly, the bonds do not constitute taxable income and the Third Circuit Court's holding to the contrary is in error.

Furthermore, inasmuch as income has been defined as a *gain* from capital or labor, the presence of loss obviates any income. This Court has recognized that "no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact" there was no economic gain. *Dobson* v. *Commissioner, supra,* 249.

Consequently, it is submitted that since there was a loss in fact incurred upon the transaction, it would be unconstitutional as well as unconscionable to tax petitioner on such loss.

Conclusion.

For the reasons stated in this brief, it is respectfully submitted that this Court should determine that there is no deficiency in federal income tax of this petitioner for the calendar year 1941; or, in the alternative, that petitioner overpaid his said tax in an amount to be recomputed upon a remand of this cause to the Tax Court, pursuant to a finding that he sustained a loss in that year of $145,857.89, which was not taken as a deduction in his return of income.

It is respectfully submitted that the decision of the Circuit Court of Appeals for the Third Circuit should be reversed and decision entered for the petitioner.

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Appendix.

Constitution and Statutes Involved.

CONSTITUTION OF THE UNITED STATES:

> Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

INTERNAL REVENUE CODE:

SECTION 22—Gross Income—

> (a) General Definition—"Gross income" includes, gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SECTION 111—Determination of Amount of, and Recognition of, Gain or Loss—

> (a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * * and the loss shall be the excess of the adjusted basis * * * over the amount realized.
>
> (c) Recognition of Gain or Loss—In the case of a sale or exchange, the extent to which the gain

or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

SECTION 112—Recognition of Gain or Loss—

(a) General Rule—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

(2) Stock for stock of same corporation—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) Stock for stock on reorganization—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(c) Gain from Exchanges not Solely in Kind—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to

the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from Exchanges Not Solely in Kind—If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(g) Definition of Reorganization—As used in this section (other than subsection (b) (10) and subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means * * *
(E) a recapitalization * * *.

SECTION 115—Distributions by Corporations—

(a) Definition of Dividend—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) Source of Distributions—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and

from the most recently accumulated earnings or profits.

(c) Distributions in Liquidation—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

(g) Redemption of Stock—If a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

SECTION 117—Capital Gains and Losses—

(b) Percentage Taken Into Account—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

* * * 50 per centum if the capital asset has been held for more than 6 months.

REVISED STATUTES OF NEW JERSEY:

Title 14, Chapter 8, Section 19:

The directors of a corporation shall not pay dividends except from its surplus * * * or from the

net profits arising from the business of the corporation, nor shall they divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock of the corporation or reduce its capital stock except as authorized by law.

In case of any willful or negligent violation of the provisions of this section, the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large upon the minutes at the time, or who, not then being present, shall have caused their dissent therefrom to be so entered upon learning of such action, shall jointly and severally be liable, at any time within six years after paying such dividend, to the stockholders, severally and respectively, to the full amount of any loss sustained by such stockholders, or in case of insolvency, to the corporation or its receiver to the full amount of any loss sustained by the corporation, by reasons of such withdrawal, division or reduction.

Title 14, Chapter 11, Section 1:

Any corporation * * * may, in the manner provided by section 14;1-2 of this title:

1. Change stock with par value, of any class or classes, into stock without par value of the same or of a different class or classes; * * *

Title 14, Chapter 11, Section 2:

The board of directors shall pass a resolution declaring that such amendment, change or alteration is advisable and calling a meeting of the stockholders to take action thereon. The meeting shall be held upon such notice as the by-laws provide, and in the absence of such provision, upon ten days' notice given personally or by mail.

If two-thirds in interest of each class of stockholders having voting powers shall vote in favor of such amendment, change or alteration, the corporation shall make a certificate thereof under its seal and the hands of its president or vice president and secretary or assistant secretary, which certificate shall be acknowledged or proved as in the case of deeds of real estate, and shall be filed in the office of the secretary of state.

Thereupon the certificate of incorporation shall be deemed to be amended accordingly, except that such certificate of amendment, change or alteration shall contain only such provision as it would be lawful to insert in an original certificate of incorporation made at the time of making such amendment, change or alteration.

The certificate of the secretary of state that such certificate has been filed in his office shall be taken and accepted as evidence of such amendment, change or alteration, in all courts and places.

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No. 209

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ADAM A. ADAMS, PETITIONER

v.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes involved	2
Statement	2
Argument	5
Conclusion	10
Appendix	11

CITATIONS

Cases:

Bass v. Commissioner, 129 F. 2d 300 ..... 5, 7, 8

Beretta v. Commissioner, 141 F. 2d 452, certiorari denied, 323 U. S. 720 7

Dobson v. *Commissioner*, 320 U. S. 489 10

Statutes:

Internal Revenue Code:

Sec. 112 (26 U. S. C. 1940 ed., Sec. 112) 5, 7, 8, 9, 10, 11

Sec. 115 (26 U. S. C. 1940 ed., Sec. 115) 6, 7, 8, 9, 10, 11

701997—46

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 95a–109a) and dissenting opinions (R. 109a–111a) are reported at 5 T. C. 351. The opinion of the Circuit Court of Appeals (R. 114a–117a) is reported at 155 F. 2d 246.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 16, 1946. (R. 118a.) The petition for a writ of certiorari was filed June 18, 1946. The jurisdiction of this Court is invoked

under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the recapitalization of a corporation, pursuant to which the taxpayer exchanged the common stock owned by him for new common stock and debenture bonds, was undertaken for a corporate business purpose, so that it is to be given effect as a reorganization within the meaning of Section 112 (g) (1) (E) of the Internal Revenue Code.

2. If the exchange was not made pursuant to a statutory reorganization, whether the Tax Court was warranted in its findings that the distribution of the bonds effected a distribution of accumulated earnings or profits under Section 115 (b) of the Internal Revenue Code and that the distribution was taxable as a dividend or its equivalent under Section 115 (a) and (g) of the Code.

STATUTES INVOLVED

The pertinent statutes are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

The facts found by the Tax Court (R. 96a–101a), so far as here pertinent, may be summarized as follows:

In the taxable year 1941 the taxpayer was principal stockholder and president of Newark

Theatre Building Corporation, which had an authorized capital of 6,000 shares of common stock of a par value of $100 per share. On January 26 of that year the taxpayer owned 5,903 shares of this stock out of a total of 5,914 which were issued and outstanding. (R. 96a.)

Pursuant to a plan formulated by the directors of the corporation in December 1940, the corporation exchanged its stock for new stock and bonds in the following manner: The authorized capital stock, of which 5,914 shares of $591,400 par value were issued and outstanding, was reduced by 50 percent, to $295,700, divided into 5,914 shares of no par value but having a stated value of $50 per share. The 5,914 shares of $100 par value capital stock were canceled and the corporation issued in exchange therefor an aggregate principal amount of $295,700 in six percent 20-year debenture bonds, plus the 5,914 shares of the new no-par common stock. The exchange was made on the basis of one new share of stock and one $50 bond for each old share. (R. 97a.)

On January 27, 1941, the taxpayer surrendered his 5,903 shares of $100 par value stock and received for each share thereof one share of no par value stock of the stated value of $50, and one $50 debenture bond. (R. 98a.)

On January 26, 1941, the corporation had accumulated earnings and profits available for distribution in a sum not less than $164,514.82. The

new debentures regularly earned and paid the interest due on them, and when received by the taxpayer had a value not less than $164,208.82. (R. 101a.)

The corporate books showed no change in its surplus account following or as a result of the distribution of the bonds. The old par capital stock account was debited in the sum of $591,400, a new no-par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. (R. 98a.)

The Commissioner determined that the taxpayer received a taxable dividend in 1941 in the form of debenture bonds to the extent of the corporation's accumulated earnings in the amount of $164,208.82, and accordingly determined a deficiency in his income tax for that year of $113,021.44. (R. 95a.) The Tax Court found that the recapitalization and distribution of debentures above described had no legitimate business purpose (R. 101a), which would qualify the transaction as a tax free reorganization within the meaning of Internal Revenue Code Section 112, and that such earnings as the corporation had were distributed by means of the debentures to the extent of their value. (R. 106a.) Accordingly, the Tax Court sustained the Commissioner's determination. (R. 108a–109a.)

The Circuit Court of Appeals affirmed. (R. 114–118a.).

ARGUMENT

The courts below both held that the transaction in which the corporation issued stock and debentures in exchange for its outstanding $100 par value stock was not a tax-free reorganization within the meaning of Section 112 (b) (3) and (g) of the Internal Revenue Code. (Appendix, *infra*, p. 11.) This holding has as its premise the view taken by both courts below (R. 102a–103a, 115a–116a), that the plan of recapitalization was not undertaken for a valid business purpose of the corporation. With respect to his argument that the existence of a corporate business purpose is not essential to the recognition for tax purposes of a recapitalization as distinguished from other forms of reorganization, the taxpayer asserts no conflict of decisions. (Pet. 8–9, Br. 19–23.) The taxpayer cannot claim a conflict on this point with *Bass* v. *Commissioner*, 129 F. 2d 300 (C. C. A. 1), because in the *Bass* case the reorganization was motivated by corporate business reasons not present here; for example, to provide the corporation with marketable treasury shares which might later be used for corporate business purposes (129 F. 2d at 303–304).[1]

[1] The four reasons advanced for the recapitalization were rejected by the Tax Court, either as not credible or as reasons personal to the stockholders rather than for the benefit of the corporation. (R. 102a–103a.) Thus, the motivations asserted were: (1) That the new bonds could be used as collateral to facilitate a refinancing of the corporation's mort-

Having reached the conclusion that the transaction here was not a tax-free recapitalization, the course was open to the courts below, if not mandatory upon them, to hold that the distribution of the debentures was a distribution, to the extent of their market value, of such earnings and profits as were in the corporate treasury, *i. e.*, a dividend or a distribution in the nature thereof,[2] and is taxable as a dividend. This treatment was called for because the issuance of the new debentures was a distribution of property in a form in which dividends may be declared and paid, and

gage indebtedness. But the bonds were never so used; moreover, the bonds were inferior to the mortgage lien itself and could not be as attractive to a secured creditor as common stock which would give him some voice in the business. (2) That the taxpayer wanted to give his sons an interest in the business without surrendering stock control. This reason was personal to the taxpayer. (3) That the corporation could save corporate franchise taxes by reducing its capital, and (4) could save income taxes by deducting the interest on the bonds. But the franchise and income tax savings were greatly exceeded by the interest payable to the bondholders, and no advantage resulted to the corporation as distinguished from its shareholders to whom the bonds were issued. The taxpayer does not challenge in this Court the finding, in which the court below concurred (R. 115a–116a), that the recapitalization here had no corporate business purpose if a corporate business purpose is required.

[2] The same result is reached here, whether the transaction is treated as a distribution of debentures within the definition of a dividend contained in Section 115 (a) (Appendix, *infra*, pp. 11–12), or as a redemption of stock at such time and in such manner as to make the distribution and cancellation or redemption the essential equivalent of a taxable dividend, under Section 115 (g) (Appendix, *infra*, p. 12).

the corporation had accumulated earnings and profits in at least the amount of the value of the debentures. Given a distribution by the corporation it follows that the distribution was a dividend, for "The term 'dividend' * * * means any distribution * * *, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *" (Internal Revenue Code, Sec. 115 (a), Appendix, *infra*, pp. 11–12); and, for the purposes of the income tax chapter of the Code, "every distribution is made out of earnings or profits to the extent thereof * * *" (*id.*, Sec. 115 (b), Appendix, *infra*, p. 12). This conclusion could not be affected by the fact that no debit was entered on the books of the corporation against its surplus account, for Section 115 (b) conclusively attributes any distribution to earnings and profits if they exist. *Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5), certiorari denied, 323 U. S. 720. It is only on this point that the taxpayer asserts a conflict with *Bass* v. *Commissioner*, *supra*. (Pet. 8, 14–18.)

There is no conflict with the *Bass* case. There the court held (129 F. 2d at 306) that there was an exchange of securities pursuant to a recapitalization having a valid business purpose and upon which, therefore, no gain or loss was to be recognized under Section 112 (b) (3) (Appendix, *infra*, p. [redacted]). The Commissioner had contended,

481
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without regard to the question whether there was a business purpose, that there was no exchange, but rather, a distribution of new preferred stock as a stock dividend, with a mere and colorless change in par value of the 600,000 shares of stock which were outstanding both before and after the transaction. The court having rejected the Commissioner's contention and having held that there was an exchange in a reorganization pursuant to Section 112 (b) (3), that section prescribed that no gain or loss was to be recognized. Then Section 115 (h) (1), (Appendix, *infra;* pp. 12–13) came into play with its provision that a distribution shall not be considered a distribution of earnings or profits if no gain to the distributee from the receipt of the new securities was recognized by law. In that view, as the court there held, Section 115 (b), which forms the basis for the holdings here, was irrelevant in that case, although the court fully recognized that if Section 115 (b) had been relevant it would have called for the same result reached here. "The latter subsection attributes a source to distributions when distributions are made * * *." (129 F. 2d at 308.) The *Bass* case does not hold, as the taxpayer here contends, that Section 115 (b) may be ignored in favor of corporate bookkeeping concepts where the requirements for a tax-free exchange under Section 112 are missing and a distribution in fact is found.

The taxpayer further maintains (Pet. 9, Br. 24–29) that though the transaction here could not qualify as an exchange in a reorganization tax-free under Section 112 (b) (3), the transaction in which it gave up common stock for common stock and debentures was nevertheless an exchange, and that its tax consequences are therefore to be governed either by Section 112 (b) (2), 112 (c) (1) and (e), or by Section 112 (a)[3]— in any event, by Section 112 to the exclusion of any treatment which might be given under Section 115. Yet it seems clear that a distribution of property such as to constitute a distribution of earnings or profits within the meaning of Section 115 (a) can occur even though something is given up by the distributee simultaneously with the distribution, and a distribution and cancellation or

[3] Section 112 (a) provides that upon a sale or exchange of property the entire gain or loss shall be recognized, except as provided in Section 112. Where Section 112 (a) is applicable and no exception is controlling the gain or loss upon an exchange of stock for stock and bonds would be taken into account and taxed at capital gains rates. The taxpayer claims to be within the exception to Section 112 (a) contained in Section 112 (b) (2), 112 (c) (1) and 112 (e), that where common stock is exchanged solely for common stock in the same corporation, except for other property issued in addition, gain shall be taken into account to the extent of the fair market value of the other property, and loss shall not be recognized. The Tax Court made no findings as to whether the taxpayer sustained a gain or loss upon the transaction. In its view that the issuance of the debentures was a distribution of earnings and profits, such an inquiry was irrelevant.

redemption within the meaning of Section 115 (g) can occur and can be the equivalent of a taxable dividend even though the distribution is in property rather than in money. The taxpayer cites no authority that a distribution otherwise taxable as a dividend cannot be so treated when it is made as a part of an exchange, or that the exchange provisions of Section 112 exclude the operation of Section 115.

The majority of the court below regarded the dispute as one in which the conclusions of the Tax Court have finality under *Dobson* v. *Commissioner,* 320 U. S. 489, both with respect to the lack of a business purpose in the reorganization and with respect to the treatment to be given to the debentures (R. 117a), although the court fully stated its agreement with the criteria used by the Tax Court (R. 116a–117a). There is no conflict of decisions.

CONCLUSION

The petition should be denied.

Respectfully submitted.

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JULY 1946.

APPENDIX

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * * *

(g) [as amended by Section 213 (b), Revenue Act of 1939, c. 247, 53 Stat. 862.] *Definition of Reorganization.*—As used in this section and section 113—

(1) The term "reorganization" means * * *, or (E) a recapitalization, * * *. (26 U. S. C. 1940 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings

or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on

behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

(26 U. S. C. 1940 ed., Sec. 115.)

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No. 209

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OCTOBER TERM, 1946

ADAM A. ADAMS, PETITIONER

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute and regulations involved	2
Statement	3
Argument	6
Conclusion	11

CITATIONS

Cases:

Baker v. *Commissioner*, 80 F. 2d 813	8
Bass v. *Commissioner*, 129 F. 2d 300	8, 9
Bazley, J. Robert, v. *Commissioner*, No. 287	2, 6, 7, 9
Beretta v. *Commissioner*, 141 F. 2d 452, certiorari denied, 323 U. S. 720	8
Commissioner v. *Estate of Bedford*, 325 U. S. 283	7, 10
Commissioner v. *Fisher*, 327 U. S. 512	9
Commissioner v. *Wheeler*, 324 U. S. 542	7
Dobson v. *Commissioner*, 320 U. S. 489	10
Doerschuck v. *United States*, 274 Fed. 739	10
Doyle v. *Mitchell Brothers Co.*, 247 U. S. 179	7
Dunton v. *Clauson*, decided September 27, 1946	8
Edwards v. *Douglas*, 269 U. S. 204	8
Faris v. *Helvering*, 71 F. 2d 610, certiorari denied, 293 U. S. 584	8
Guild v. *Commissioner*, 19 B. T. A. 1186	9
Hellmich v. *Hellman*, 276 U. S. 233	9
Helvering v. *Canfield*, 291 U. S. 163	8
Helvering v. *Midland Ins. Co.*, 300 U. S. 216	7
Helvering v. *Sprouse*, 318 U. S. 604	9
Leland v. *Commissioner*, 50 F. 2d 523, certiorari denied, 284 U. S. 656	8
Tate v. *Commissioner*, 97 F. 2d 658, certiorari denied, 305 U. S. 639	8
Wilcox v. *Commissioner*, 137 F. 2d 136	8

Statutes:

Internal Revenue Code:

Sec. 112 (26 U. S. C. 1940 ed., Sec. 112)	9
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	8
Sec. 1118 (26 U. S. C. 1940 ed., Sec. 1118)	1

Miscellaneous:

II Cook, Corporations (8th ed., 1923), Sec. 535, p. 1849	10

726511—47

In the Supreme Court of the United States

OCTOBER TERM, 1946

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OPINIONS BELOW

The opinion of the Tax Court (R. 95–109) and the dissenting opinions (R. 109–111) are reported at 5 T. C. 351.[1] The opinion of the Circuit Court of Appeals (R. 114–117) is reported in 155 F. 2d 246.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 16, 1946. (R. 118.) The petition for a writ of certiorari was filed June 18, 1946, and was granted on October 14, 1946.

[1] The Division report (R. 83–94) is not properly a part of the record. Section 1118 (b), Internal Revenue Code (26 U. S. C. 1940 ed., Sec. 1118).

(R. 119.) The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Pursuant to a plan of recapitalization, the taxpayer-stockholder exchanged his stock for new stock and debentures in the same corporation. The debentures were worth, not less than $164,000 when distributed and the corporation had accumulated earnings and profits of at least that amount. The corporate books showed no change in surplus as a result of the transaction. The principal question is whether the recapitalization, pursuant to which the exchange was made, was undertaken for a corporate business purpose, so that it is to be given effect as a tax-free reorganization under Section 112 of the Internal Revenue Code and Section 19.112 (g) of Treasury Regulations 103.

2. Whether the distribution of the debentures effected a distribution of the accumulated earnings and profits, taxable as an ordinary dividend under Sections 22 (a) and 115 of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix to the Commissioner's brief in *J. Robert Bazley* v. *Commissioner*, No. 287, present Term, a companion case to be argued consecutively with the present case.

STATEMENT

The pertinent facts found by the Tax Court (R. 96–101) may be summarized as follows:

In the taxable year 1941 the taxpayer was principal stockholder and president of Newark Theatre Building Corporation, a New Jersey corporation, which had an authorized capital of 6,000 shares of common stock of a par value of $100 per share. On January 26 of that year the taxpayer owned 5,903 shares of this stock out of a total of 5,914 which were issued and outstanding. (R. 96.)

On December 6, 1940, the directors of the corporation met to consider the desirability of revamping the capital structure of the company. The president pointed out that, in his opinion, the whole capital structure was not well balanced, and that it was not good business to have so top-heavy a capital set-up. He stated that a simple plan of recapitalization could be evolved which would bring about the desired change at comparatively little expense to the company; that he had consulted legal and accounting counsel, who could see no difficulty in consummating the plan of recapitalization. (R. 96–97.)

The following plan was then proposed and adopted (R. 97):

> (1) A reduction in the authorized capital stock from $600,000 represented by 6,000 shares of a par value of $100 each, of which 5,914 shares, or $591,400 are issued and

outstanding, to $295,700, to be divided into 5,914 shares without nominal or par value.

(2) The issuance of debenture bonds in the aggregate principal amount of $295,700, bearing interest at the rate of six percent per annum, payable semi-annually, the principal to be payable in 20 years from the date thereof, plus 5,914 shares of the new no-par common stock, in exchange for the present shares of capital stock, on the basis of one $50 bond and one share of no-par value common stock for each of the present $100 par value shares surrendered.

The directors adopted the appropriate resolution to amend the certificate of incorporation to provide for the reduction of authorized capital, and the issuance of no-par value stock, and the stockholders duly ratified and approved the actions of the directors with respect thereto. (R. 97.)

It was anticipated that there would be a saving of New Jersey franchise taxes in excess of $400 per year and a reduction of the corporation's federal income tax liability in substantial amounts each year by the deduction of the interest paid on the bonds. (R. 97.)

The recapitalization was carried out in accordance with the plan. Taxpayer on January 27, 1941, surrendered his 5,903 shares of $100 par value stock, and received for each share thereof one share of no-par value stock of a stated value

of $50, and one $50 debenture bond. The bondholders were to rank *pari passu* with unsecured creditors in event of dissolution. (R. 98.)

On January 26, 1941, the corporation had accumulated earnings and profits available for distribution in a sum not less than $164,514.82. The new debentures regularly earned and paid the interest due on them, and when received by the taxpayer had a value not less than $164,208.82. (R. 101.)

The corporate books showed no change in its surplus account following or as a result of the distribution of the bonds. The old par capital stock account was debited in the sum of $591,400, a new no-par capital stock account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. (R. 98.)

The Commissioner determined that the taxpayer received a taxable dividend in 1941 in the form of debenture bonds to the extent of the corporation's accumulated earnings in the amount of $164,208.82, and accordingly determined a deficiency in his income tax for that year. The Tax Court explicitly found that "the recapitalization and distribution of debentures above described had no legitimate business purpose" (R. 101), which would qualify the transaction as a tax-free reorganization within the meaning of Internal Revenue Code Section 112, and that such earnings

as the corporation had were distributed by means of the debentures to the extent of their value. (R. 108–109.) Accordingly, the Tax Court sustained the Commissioner's determination. (R. 109.)

The Circuit Court of Appeals affirmed. (R. 114–117.)

ARGUMENT

This case presents the same basic issues as those in the *Bazley* case, No. 287, and reference is here made to our brief in that case which sets forth in full the basic arguments in support of the Commissioner's position both there and here.

As pointed out by the Circuit Court of Appeals (R. 114), the reasons given for the recapitalization here differ somewhat from the ones in the *Bazley* case, but the differences do not change the result; here, as in the *Bazley* case, the Tax Court specifically found (R. 101) that the recapitalization and distribution of debentures had no legitimate corporate business purpose, and the Circuit Court of Appeals accepted that finding (R. 116). The principal purpose assigned was that the creation of debenture bonds would facilitate refinancing. The Tax Court did not believe that this purpose had actually existed. (R. 102.) The second reason, according to the taxpayer, was his desire to give some securities of the corporation to his sons without surrendering any of his own stock control. (R. 102–103.)

This was a reason purely personal to the taxpayer and served his individual interests as distinguished from the corporate interests. The remaining two reasons were the saving of corporate income taxes resulting from the deduction of interest paid on the bonds and the saving of New Jersey franchise taxes resulting from the decrease in the amount of stock. (R. 103.) These asserted reasons promised such slight advantages to the corporation when compared with the burdens imposed by creating the corporate indebtedness that the Tax Court correctly concluded that the fact that the taxpayer was the dominant stockholder evidently largely accounted for the transaction. (R. 103–104.)

The other point of departure from the *Bazley* case, also noted by the Circuit Court of Appeals (R. 116), is that here the company's book surplus was not affected by the distribution. However, it in fact had available earnings and profits of some $164,000, accumulated since February 28, 1913, and the debentures were worth at least that amount at the time of distribution (R. 101). That is enough to sustain the tax.

It is settled that the taxpayer's accounting methods are not controlling for tax purposes (*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 187; *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 223; *Commissioner* v. *Wheeler*, 324 U. S. 542, 546; *Commissioner* v. *Estate of Bedford*, 325 U. S. 283,

292), and it is also settled that every distribution must be deemed to be made from earnings or profits accumulated after February 28, 1913, if there are any on hand and available for distribution. The statute (Sec. 115 (b), Internal Revenue Code) expressly so provides, and such provisions are unquestionably valid. *Edwards* v. *Douglas*, 269 U. S. 204, 216–217; *Helvering* v. *Canfield*, 291 U. S. 163; *Beretta* v. *Commissioner*, 141 F. 2d 452 (C. C. A. 5th), certiorari denied, 323 U. S. 720; *Tate* v. *Commissioner*, 97 F. 2d 658 (C. C. A. 8th), certiorari denied, 305 U. S. 639; *Faris* v. *Helvering*, 71 F. 2d 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Wilcox* v. *Commissioner*, 187 F. 2d 136 (C. C. A. 9th); *Leland* v. *Commissioner*, 50 F. 2d 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656; *Dunton* v. *Clauson* (D. Maine), decided September 27, 1946 (1946 C. C. H., par. 9354).

To the extent that *Bass* v. *Commissioner*, 129 F. 2d 300 (C. C. A. 1st), may be considered at variance with the views herein expressed, we submit that it was incorrectly decided, but in any event it is distinguishable from both the *Bazley* case and the instant one because the transaction was motivated by corporate business reasons; moreover, it did not involve a distribution of debentures but a distribution of preferred stock which seems to have amounted to a nontaxable

stock dividend under *Helvering* v. *Sprouse*, 318 U. S. 604. The court in the *Bass* case appears to have taken the view that where there is an exchange, there can not be a distribution. See 129 F. 2d 300, 308. But, as shown in our brief in the *Bazley* case, such a view is unsound. A distribution cannot be effectively disguised for tax purposes by casting it in the form of a reorganization. There is no magic in the reorganization sections through which taxpayers can change what is plainly income into capital and thus escape taxation. Cf. *Commissioner* v. *Fisher*, 327 U. S. 512.

Here there was no liquidation and hence there is no basis for the application of *Hellmich* v. *Hellman*, 276 U. S. 233, which held that amounts distributed to the stockholders of a liquidating corporation out of earnings and profits accumulated by the corporation since February 28, 1913, are not to be treated as ordinary dividends but as payments made by the corporation in exchange for its stock. The instant corporation, like the one in the *Bazley* case, was a going concern (cf. *Guild* v. *Commissioner*, 19 B. T. A. 1186), and we do not understand that the taxpayer contends otherwise.

The taxpayer contends (Br. 15 ff.) that if the debentures are taxable at all, they should be treated as "boot" under Section 112 (c) and (e)

so that only the gain upon the exchange, viewed as a whole, would have to be accounted for. He says that there was in reality a loss and that the Tax Court's findings are deficient in not showing this. The answer to that contention is that under *Commissioner* v. *Estate of Bedford, supra,* it was certainly open to the courts below to hold, as they did, that the debenture distribution amounted to a dividend to the extent that earnings were available. A distribution in property can qualify as a dividend equally as well as one in cash (*Doerschuck* v. *United States,* 274 Fed. 739 (E. D. N. Y.); II Cook, Corporations (8th ed., 1923), Sec 535, p. 1849), and in the circumstances there was no reason for the Tax Court to consider any questions with respect to capital gain or loss. In view of the conclusion that the issuance of the debentures was a distribution of earnings and profits, such an inquiry was irrelevant.

To the extent that this case can be reduced to its own particular circumstances, and does not turn on a generalizing principle, the Tax Court's determination should be accepted as final under *Dobson* v. *Commissioner,* 320 U. S. 489. The Circuit Court of Appeals below properly took that view. (R. 117.) And see *Commissioner* v. *Estate of Bedford, supra.*

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted,

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